92-873

No. _____

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1992

ALLSTATE INSURANCE COMPANY,
Petitioner,

vs.

CONSTANCE V. FOSTER, Insurance Commissioner of the Commonwealth of Pennsylvania, as Statutory Rehabilitator of The Mutual Fire, Marine and Inland Insurance Company, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

PETITION FOR A WRIT OF CERTIORARI OF ALLSTATE INSURANCE COMPANY

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QUESTIONS PRESENTED FOR REVIEW

1. Does a Pennsylvania statutory scheme which permits its courts to confirm a rehabilitation plan of a defunct insurance company with terms abrogating contractual arbitration rights of the insurance company's creditors constitute the regulation of the "business of insurance" under the McCarran-Ferguson Act, 15 U.S.C. §1012(b), thus preempting the applicability of the Federal Arbitration Act, 9 U.S.C. §2, which is binding on states under the Supremacy Clause, U.S. Const., art. VI, cl. 2?

2. Does the Plan of Rehabilitation for a defunct Pennsylvania insurance company promulgated and confirmed pursuant to state law deprive a creditor of such company of its property without due process of law in violation of the Fourteenth Amendment to the United States Constitution or impair the obligations of its contracts in violation of the Contracts Clause, U.S. Const., art. I, §10, cl. 1, if the plan restricts the creditor's contractual setoff rights or restricts the creditor's contractual rights in respect of its collateral?

PARTIES TO THIS PETITION

Petitioner

Allstate Insurance Company

Respondents

Constance B. Foster, Insurance Commissioner of the Commonwealth of Pennsylvania, as Statutory Rehabilitator of The Mutual Fire, Marine and Inland Insurance Co.

Committee of Policyholders

Colonial Penn Group, Inc.

AIG Risk Management

Pepsi-Cola Bottling Co. of Charlotte, Inc.

Fireman's Fund Insurance Co.

Evanston Insurance Co.

RLI Insurance Co.

Pennsylvania Insurance Guaranty Assn.

Member Companies of Republic Insurance Group

LIST OF PARTIES TO THE PROCEEDING IN THE SUPREME COURT OF PENNSYLVANIA

Constance B. Foster, Insurance Commissioner of the Commonwealth of Pennsylvania, as Statutory Rehabilitator for The Mutual Fire, Marine and Inland Insurance Co.

Allstate Insurance Company

Committee of Policyholders

Colonial Penn Group, Inc.

AIG Risk Management

Pepsi-Cola Bottling Co. of Charlotte, Inc.

Fireman's Fund Insurance Co.

Evanston Insurance Co.

RLI Insurance Co.

Pennsylvania Insurance Guaranty Assn.

Member Companies of Republic Insurance Group

RULE 29.1 STATEMENT

Parent:

Sears, Roebuck and Co. (USA)

Non-wholly owned subsidiaries:

ABP Midwest, Inc. (USA)
Allscrips Pharmaceuticals, Inc. (USA)
Associated Gas Resources, Inc. (USA)
Burkhart—AS 1983 Limited Partnership (USA)
DM Management Company (USA)
Fallowfield Developers Limited Parnership (USA)
Quantitative Data Systems, L.P. (USA)
Sanguine/A Anaderko, Ltd. (USA)
Sangatuck, II Cellular Investment Corp. (USA)
Science Center Associates (USA)
Scripps Center Associates (USA)
Washington Business Park Associates (USA)

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PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

PETITION FOR A WRIT OF CERTIORARI

Petitioner respectfully petitions this Court for a writ of certiorari to review and reverse the judgment of the Supreme Court of Pennsylvania which affirmed the lower court's confirmation of a Plan of Rehabilitation ("Plan") for an insolvent insurance company, Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire"), pursuant to the insurance company insolvency statutes of the Commonwealth of Pennsylvania. The Plan (i) abrogated Petitioner's arbitration rights under contracts with Mutual Fire as protected by the Federal Arbitration Act, applicable to the states through the Supremacy Clause of the United States Constitution; and (ii) restricted Petitioner's setoff rights under contracts with Mutual Fire and restricted Petitioner's rights as a secured creditor to its collateral, in violation of the Due Process Clause of the Fourteenth Amendment and the Contracts Clause, U.S. Const., art. I, §10, cl. 1.

OPINIONS BELOW

The opinion of the Supreme Court of Pennsylvania, *Foster v. Mutual Fire, Marine and Inland Insurance Company* (Pet. App. A1) was not officially reported as of the date of this petition. The opinion of the Commonwealth Court of Pennsylvania, *Grode v. Mutual Fire, Marine and Inland Insurance Company* (Pet. App. A42) is reported at 132 Pa. Commw. 196, 572 A.2d 798 (1990).

JURISDICTION

The judgment of the Pennsylvania Supreme Court approving in relevant part the Plan of Rehabilitation was entered on August 21, 1992. The jurisdiction of the Court is invoked under 28 U.S.C. §1257(a).

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The following constitutional and statutory provisions are involved in this petition, and are set forth in the Appendix beginning at Pet. App. A124.

U.S. Const., art. I, §8, cl. 3.
U.S. Const., art. I, §10, cl. 1.
U.S. Const., art. VI, cl. 2.
U.S. Const., amend. XIV, §1.

9 U.S.C. §2.
15 U.S.C. §1012(b).
31 U.S.C. §3713.

40 P.S. §221.15(a).
40 P.S. §221.32(a).

STATEMENT OF THE CASE

The Petitioner in this case is an insurance company which was both reinsured by and a reinsurer of Mutual Fire under reinsurance contracts. The reinsurance contracts contained provisions requiring the parties to the contracts to arbitrate all disputes, including claims for the payment of money. The contracts also contained provisions permitting the offset of mutual claims between the parties. In addition, Petitioner's claims against Mutual Fire under the reinsurance contracts were secured in part by a collateral trust and certain letters of credit issued by banks for Petitioner's benefit.

This dispute began when insolvency proceedings were commenced against Mutual Fire pursuant to Pennsylvania's insurance insolvency statutes. 40 P.S. §221.1 *et seq.* In 1986, the Commissioner of Insurance for the Commonwealth of Pennsylvania ("Commissioner"), a Respondent in this cause, was appointed Rehabilitator pursuant to 40 P.S. §221.15(a) by the Pennsylvania Commonwealth Court. The Commissioner promulgated the Plan (Pet. App. A82) and, on January 23, 1990, the Plan was approved by the Commonwealth Court with some modifications not relevant to this petition (Pet. App. A71). Several of the parties, including Petitioner, appealed this judgment to the Pennsylvania Supreme Court, which consolidated all the appeals. By judgment dated August 21, 1992, the Supreme Court of Pennsylvania affirmed the Commonwealth Court's decision in all respects material to this petition. This petition seeks review of that decision as it relates to the issues of (i) the abrogation of contractual rights to arbitration, and (ii) the impairment of contractual rights of setoff and contractual rights to collateral.

Contractual Right of Arbitration

Section X of the Plan (Pet. App. A112), as approved by the Pennsylvania courts, governs disputes other than disputes concerning "Claims"[1] against Mutual Fire. Disputes as to Claims are governed by Section VII of the Plan (Pet. App. A108). Section X permits any party to a non-Claim dispute subject to an arbitration clause to "which all such parties would be bound absent these Rehabilitation proceedings" to request the Commonwealth Court to have the dispute resolved by that court instead of by arbitration and requires the Commonwealth Court to grant that request if it is in the best interest of the estate. Section VII provides that Claim disputes may be decided by the Commonwealth Court or by a referee or special master appointed by that court. Section VIII recognizes the Commonwealth Court's jurisdiction to hear, determine and "where appropriate refer to arbitration" all disputes concerning Claims and non-Claims. Thus, the Plan restricts Petitioner's contractual right to arbitration because Section X requires the party seeking arbitration to request and obtain approval of the Commonwealth Court and Section VIII gives the court the power to hear the case in lieu of arbitration or to refer the case to a referee or special master.

Because the Plan does not *require* arbitration of all Claim and non-Claim disputes governed by a contractual arbitration clause, the Plan runs afoul of the Federal Arbitration Act, 9 U.S.C. §§1-16, which is binding on the states through the Supremacy Clause. *Southland Corp. v. Keating*, 465 U.S. 1, 11 (1984).[2]

[1] "Claims" are defined under the Plan as assertions against Mutual Fire for payment. (Pet. App. A87).

[2] The Commonwealth Court determined in two cases filed by the Mutual Fire Rehabilitator that Claim disputes should be resolved by arbitration. *Foster v. Philadelphia Manufacturers*, 140 Pa. Commw. 186, 592 A.2d 131 (1991); *Foster v. Home Ins. Co.*, 140 Pa. Commw.

(Footnote continued on following page.)

The Commonwealth Court is an appellate court of original jurisdiction over insurance company insolvency proceedings. The Mutual Fire insolvency proceeding was one of the largest ever filed in any state. The Commonwealth Court, perhaps of necessity due to the size of the case, treated the entire proceeding as if it were an insolvency administrative proceeding. There were no guidelines, as in federal bankruptcy proceedings, on the manner in which Plan objections could be raised. Certain banks, the policyholders, the United States government, and many other insurance companies filed a plethora of objections to virtually every provision of the Plan.

In a pre-confirmation hearing brief, Petitioner objected to many provisions of the Plan, including but limited to, the unconstitutional taking of Petitioner's collateral and setoff rights. In addition, Petitioner objected to the Plan's abrogation of its contractual right to arbitrate disputes. At the confirmation hearing, Petitioner orally argued that the Plan violated its contractual right to arbitrate disputes. Petitioner's brief and oral statement in the Commonwealth Court did not

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(Footnote continued from preceding page.)
184, 592 A.2d 130 (1991). In both cases, the court recognized that the arbitration provisions of the reinsurance contracts between the parties were not abrogated by the Plan and did not divest the court of jurisdiction over the disputes. The court held that since the Rehabilitator's complaint did not constitute a petition for the court to hear the matter in lieu of arbitration as contemplated under Section X of the Plan, the court dismissed the complaint and ordered the parties to arbitrate. The court stated that the proper procedure under the Plan is to file a petition requesting the court to hear the matter in lieu of arbitration, which the court held it could grant "in its discretion." As will be argued below in Part I.B., the court had no discretion to grant such a petition if the Rehabilitator had filed one, because the Supremacy Clause requires states to honor contractual arbitration provisions under the Federal Arbitration Act. The applicability of the Federal Arbitration Act was not addressed by the Commonwealth Court in either of these cases.

specifically mention the Federal Arbitration Act and its conflict with the McCarran-Ferguson Act, 15 U.S.C. §§1011-15, as is discussed below.

The Commonwealth Court's order contained two sentences which addressed the arbitration issue: "Likewise, we approve Section X.A, governing disputes other than claims subject to arbitration. We construe this section as permitting parties to a dispute to *request* Commonwealth Court resolution in lieu of arbitration." (Pet. App. A66). The court apparently determined that the right of a party to request the court to decide a non-Claim dispute in lieu of arbitration did not substantially impair the rights of the contracting parties. In addition, the Commonwealth Court did not address Petitioner's assertion that Section VII of the Plan severely restricted Petitioner's arbitration rights with respect to Claims.

In its jurisdictional statement filed in the Pennsylvania Supreme Court, Petitioner raised, *inter alia*, the following issue: "Did the [Commonwealth] Court err in approving the Plan which contains provisions and procedures for dispute and claim resolution in contravention of Appellant's rights under agreements with Mutual Fire and in contravention of Appellant's constitutional rights?" The Commissioner filed an objection to this and other issues, on the grounds that they were not raised by Petitioner in the Commonwealth Court. The Pennsylvania Supreme Court never ruled on that objection.

Petitioner's brief to the Supreme Court of Pennsylvania restated its objection to the Plan's abrogation of its contractual right to arbitration, but did not specifically reference the Federal Arbitration Act. In her brief before the Pennsylvania Supreme Court, the Commissioner addressed the Petitioner's claim together

with the claims made by other creditors which had filed objections to confirmation. In her brief, the Commissioner stated as follows:

> Further, as in the Federal Priority Act analysis . . . the relevant provisions of the McCarran-Ferguson Act preclude application of the Federal Arbitration Act, 9 U.S.C. Sections 1-15 (West 1970 & Supp. 1989), in the context of a rehabilitation.

(Rehabilitator's Brief to Pennsylvania Supreme Court, at p. 90).[3]

The Pennsylvania Supreme Court affirmed without analysis the decision of the Commonwealth Court: "Additionally, Section X.A, concerning dispute resolution of claims other than those subject to arbitration, was likewise approved below. The court's interpretation that the provision permits parties to a dispute to *request* the Commonwealth Court's intervention and resolution in lieu of arbitration is correct. We find no grounds for our intervention here."[4] (Pet. App. A36).

Contractual Setoff and Secured Claims Treatment

Petitioner's contracts with Mutual Fire contain setoff clauses that allow each party to offset balances due the other party. Section III of the Plan modifies and restricts the contractual right of setoff (Pet. App. A98).

[3] The Commissioner also included in her brief to the Pennsylvania Supreme Court an extensive discussion of the conflict between the McCarran-Ferguson Act and the Federal Superpriority Act. *Id.* at 46-54. The conflict between these federal statutes was raised by the United States, which objected to the priority treatment of its Claims.

[4] Although the Pennsylvania Supreme Court did not address the conflict between the McCarran-Ferguson Act and the Federal Arbitration Act, the court did address the conflict between the McCarran-Ferguson Act and the Federal Superpriority Act, which was raised by the United States. The court affirmed the Commonwealth Court's decision to require the Commissioner to set aside funds to pay Claims of the United States government, and did not decide whether the McCarran-Ferguson Act applied.

The Plan contains two alternative forms of permitted setoff, a standard setoff provision and an optional setoff provision. While the optional definition of setoff is less restrictive to creditors such as Petitioner than the standard definition of setoff, both types severely restrict the contractual right of setoff primarily by limiting the types of claims that can be used in calculating the setoff and restricting the time periods for the calculation of setoff.[5] Significantly, the Pennsylvania statute provides for setoff of mutual claims (except for premiums) in the context of the liquidation of an insolvent insurer. 40 P.S. §221.32. The limitations and restrictions on setoff contained in the Plan severely restrict Petitioner's right to setoff mutual debts as it could do in a liquidation.

In addition to its contractual setoff rights, Petitioner's claims against Mutual Fire were secured, in part, by a collateral trust created under a Security Trust Agreement with Mutual Fire and by letters of credit issued by financial institutions for the benefit of Petitioner. Under the terms of the Security Trust Agreement, Petitioner had the unilateral right to withdraw the trust corpus at any time. In addition, Petitioner had the unqualified right to draw on the various letters of credit at Petitioner's discretion.

[5] Under the standard definition of setoff found in Section III.D of the Plan, Petitioner's setoff rights are determined by a review of reported paid losses and loss adjustment expenses as of December 4, 1986. Case reserves and claims that have been incurred but not reported (commonly referred to in the reinsurance industry as "IBNR") are completely excluded from the setoff calculations. Under the "optional" definition of setoff found in Section III.E of the Plan, case reserves and IBNR are factored into the calculation of setoff on a limited basis, although restricted to case reserves and IBNR reported as of December 4, 1986. In order to elect the "optional" definition of setoff, Petitioner had to make an election within 90 days after approval of the Plan and pay Mutual Fire any balance owed. Petitioner believes that in a liquidation, Petitioner would be permitted to offset all mutual claims, including paid losses, loss adjustment expenses, case reserves, and IBNR, thus providing Petitioner substantially greater setoff rights than under either the standard or the "optional" calculation of setoff under the Plan.

Section I of the Plan severely restricts Petitioner's access to the trust and proceeds from the letters of credit (Pet. App. A87). All attempts by secured creditors to resort to collateral require the approval of the Rehabilitator or the Court. Access to the collateral is limited to only a certain portion of the secured debt. Moreover, the defunct insurance company continues to receive interest on Petitioner's collateral which, of course, would not occur if Petitioner could resort to its collateral as permitted under its reinsurance contracts with Mutual Fire.

In both the Commonwealth Court and the Pennsylvania Supreme Court, Petitioner argued that Sections I and III of the Plan impermissibly impaired Petitioner's contractual rights in violation of the constitutional limitations placed on insurance rehabilitation proceedings by this Court in *Neblett v. Carpenter*, 305 U.S. 297 (1938). *Neblett* held that the Due Process Clause and the Contracts Clause require that creditors of insurance companies receive under a rehabilitation plan at least what they would receive in liquidation. While the Pennsylvania Supreme Court purported to recognize the constitutional limitations imposed by *Neblett* (Pet. App. A14), the Court nevertheless upheld the decision of the Commonwealth Court approving the Plan, which restricted Petitioner's contractual setoff rights and contractual right to resort to its collateral. The Pennsylvania Supreme Court determined that the impairment of setoff rights under the Plan fell within the discretion of the statutory rehabilitator of Mutual Fire. While the Court did not specifically address that portion of Petitioner's appeal related to the treatment of secured claims, the Court disposed of all of the impairment of contract arguments by concluding that the Plan did not substantially or impermissibly impair any contracts.

REASONS FOR GRANTING THE WRIT

This Court should grant this petition for writ of certiorari (i) to resolve a conflict which has developed among federal and state courts concerning the applicability of the McCarran-Ferguson Act to state insurance company insolvency statutes which permit the abrogation of contractual arbitration rights in violation of the Federal Arbitration Act; and (ii) to define the constitutional limitations on abrogation of contractual rights under a plan of rehabilitation authorized and approved under state law. Petitioner seeks a holding by this Court that the McCarran-Ferguson Act does not apply to state insurance company insolvency statutes and that the Federal Arbitration Act prevents states from abrogating contractual arbitration rights in insurance company insolvency proceedings administered pursuant to those state statutes. Petitioner further seeks a holding by this Court that contractual rights of setoff and contractual rights as a secured creditor are substantial rights that cannot be materially impaired by a plan of rehabilitation for an insolvent insurer under state law.

A significant federal question exists because of the conflict between the apparent applicability of the McCarran-Ferguson Act and the applicability of the Federal Arbitration Act. Which of those two statutes does the Supremacy Clause of the United States Constitution require the states to follow? The McCarran-Ferguson Act should not be interpreted so broadly as to allow states to restrict or abrogate the rights of the insurance company's creditors in violation of the Federal Arbitration Act.

Similarly, interpretation of state law so as to permit the approval of a plan of rehabilitation for an insolvent insurer that contains provisions abrogating or substantially restricting other contractual rights involves a significant federal issue because of the constitutional limitations placed on such plans by the *Neblett* decision.

The number of insurance company insolvencies has increased over the past few years. At stake are the commercial expectations of all the participants in the insurance industry. The conflict between the McCarran-Ferguson Act and the Federal Arbitration Act is a continuing problem that needs an immediate resolution. The continuing conflict between the states' interest in insurance insolvency proceedings and federally protected contract rights also needs further refinement. Thus, there is a significant public interest in the resolution of these important issues. The lower federal courts and state courts have reached conflicting decisions on these issues. *See* Sup. Ct. R. 10.1(b), 10.1(c).

I. The Apparent Conflict Between Application of the Federal Arbitration Act and the McCarran-Ferguson Act Involves Important Federal Questions.

A. Under the Supremacy Clause, the Federal Arbitration Act prevents states from abrogating contractually-created arbitration rights.

The Federal Arbitration Act, 9 U.S.C. §§1-16, is designed to ensure the enforceability of agreements to arbitrate disputes arising out of maritime transactions and transactions involving commerce. *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 (1967); *Southland Corp. v. Keating*, 465 U.S. 1, 11 (1984). The Act declares agreements to arbitrate to be "valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C.A. §2 (West 1970).

The Federal Arbitration Act represents the expression of Congressional policy favoring the use of arbitration over resort to the judicial system, whenever the parties to the dispute have so agreed. *Southland*, 465 U.S. at 11. This Court has repeatedly applied the Act liberally. *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 226 (1987); *Dean Witter Reynolds v. Byrd*, 470 U.S. 213, 221 (1985) (the preeminent concern of Congress in passing the Act was to enforce private agreements, and that concern requires that the courts "rigorously enforce agreements to arbitrate, even if the result is piecemeal litigation").

Cf. *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*, 460 U.S. 1, 25-26 (1983).

The Federal Arbitration Act, which derives its authority from the Commerce Clause, U.S. Const., art. I, §8, cl. 3, is binding on the states under the Supremacy Clause, U.S. Const., art. VI, cl. 2. *Southland*, 465 U.S. at 11. In *Southland*, this Court held that the Act is a substantive rule of federal law applicable in both federal and state courts. *Id.* at 12-16. *See, also, Moses H. Cone*, 460 U.S. at 25 and n.32 (1983). By enacting this legislation, Congress "withdrew the power of the states to require a judicial forum for the resolution of claims which the contracting parties agreed to resolve by arbitration." *Southland*, 465 U.S. at 10.

Absent an exception to the Federal Arbitration Act, the Supremacy Clause bars the Commonwealth of Pennsylvania from confirming an insurance company insolvency plan which abrogates Petitioner's contractual right to arbitrate its claims against the insurance company. Yet that is precisely what occurred in the case at bar. Only if an exception to the rule applies should this Court permit the decision of the Pennsylvania Supreme Court to stand.

B. The lower courts have split on the issue of whether the McCarran-Ferguson Act precludes the applicability of the Federal Arbitration Act.

Does the McCarran-Ferguson Act, 15 U.S.C.A. §§1011-15 (West 1976) create an exception to the *Southland* rule requiring states to enforce arbitration agreements? The McCarran-Ferguson Act provides in relevant part:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance. . . .

15 U.S.C.A. §1012(b) (West 1976). If Pennsylvania's statutory provisions governing insolvent insurance companies constitute regulation of the "business of insurance" and the Federal Arbitration Act would "invalidate, impair, or supersede" such regulations, the Federal Arbitration Act would not be applicable and Pennsylvania could properly deny Petitioner its contractual right to arbitrate.[6] While the better view is that a state's insurance insolvency proceedings do not constitute regulation of the "business of insurance," there is a division of authority among the federal and state courts on this issue, making this case an ideal platform for this Court's guidance.

[6] Petitioner asserts that the provisions of the Federal Arbitration Act do not "invalidate, impair, or supersede" laws enacted by states for the purpose of regulating the "business of insurance." The courts in *Miller v. National Fidelity Life Insurance Co.*, 588 F.2d 185 (5th Cir. 1979) and *Ainsworth v. Allstate Insurance Co*, 634 F. Supp. 52, 57 (W.D. Mo. 1985), so found. If the insurance laws are not invalidated, impaired or superseded by the Federal Arbitration Act, the right to arbitrate would still exist because the federal statutes would not be in conflict. However, the cases cited below in the text address the perceived conflict between the McCarran-Ferguson Act and the Federal Arbitration Act.

The following cases are among those that have held that state statutes dealing with the involvency of insurance companies do not constitute regulation of the "business of insurance" under the McCarran-Ferguson Act, and therefore a creditor's contractual right to arbitration cannot be abrogated in liquidation proceedings conducted under those statutes. *Bennett v. Liberty National Fire Ins. Co.*, 968 F.2d 969, 973 (9th Cir. 1992); *Phillips v. Lincoln National Health & Casualty Ins. Co.*, 774 F. Supp. 1297, 1299-1300 (D. Colo. 1991) (following Judge Jones' dissent in *Fabe v. United States Dept. of Treasury*, 939 F.2d 341, 353 (6th Cir. 1991), *cert. granted, United States Dept. of Treasury v. Fabe*, 112 S. Ct. 1934, 118 L. Ed. 2d 541 (1992)); *Ainsworth v. Allstate Ins. Co.*, 634 F. Supp. 52 (W.D. Mo. 1985); *Garamendi v. Caldwell*, No. CV-91-5912, 1992 WL 203827 (C.D. Cal. 1992.[7] *Cf. Triton Lines, Inc. v. Steamship Mutual Underwriting Ass'n*, 707 F. Supp. 277, 278-79 (S.D. Tex. 1989) (state law barring arbitration of claims between insurer and insured is not regulation of the "business of insurance"; therefore, the McCarran-Ferguson Act does not apply and arbitration rights must be preserved).

[7] *Fabe*, a case which this court has accepted for review, deals with the conflict between the McCarran-Ferguson Act and the Federal Superpriority Act, 31 U.S.C.A. §3713 (West 1983), rather than the Federal Arbitration Act. However, *Fabe*, which will be discussed further below, involves the same legal issue as the Federal Arbitration Act cases; that is, the applicability of the McCarran-Ferguson Act in insurance insolvency proceedings.

The rationale used in these cases is founded upon a distinction between regulating activities of insurance *companies* as opposed to regulating the *business* of insurance. *See, Bennett*, 968 F.2d at 972-73. The Ninth Circuit Court of Appeals stated, "as soon as a liquidation order is filed, neither the insurance company nor the policyholders exist any longer. All that remains is a statutory receiver and creditors of the insolvent's estate." *Id.* at 973. When an insurance company becomes defunct and the process of liquidation commences, the state is no longer regulating the business of insurance. *Id.*

The following courts have adopted the opposing view with regard to this issue: *Eden Financial Group, Inc. v. Fidelity Bankers Life Ins. Co.*, 778 F. Supp. 278, 280-82 (E.D. Va. 1991) (comprehensive state statutory scheme including provisions for the conservation and rehabilitation of insurance companies constitutes regulating the "business of insurance," thus precluding the applicability of the Federal Arbitration Act); *Washburn v. Corcoran*, 643 F. Supp. 554, 556 (S.D.N.Y. 1986) (same).

The court in *Eden Financial Group* held that state insurance insolvency statutes constitute the regulation of "the business of insurance" because an insolvency proceeding "necessarily implicates the transfer or spreading of policyholders [sic] risk and is an integral part of the relationship between the insurer and insured." *Eden Financial Group*, 778 F. Supp. at 281.

The courts addressing the issue of the conflict between the McCarran-Ferguson Act and the Federal Arbitration Act in the context of state insurance insolvency statutes have relied on cases which have

addressed the conflict between the McCarran-Ferguson Act and the Federal Superpriority Act, 31 U.S.C.A. §3713 (West 1983). As this Court well knows, conflict exists among the Federal Circuit Courts on this narrow issue. *See Fabe v. United States Dept. of Treasury*, 939 F.2d 341, 353 (6th Cir. 1991) (McCarran-Ferguson Act applies), *cert. granted, United States Dept. of Treasury v. Fabe*, 112 S. Ct. 1934, 118 L. Ed. 2d 541 (1992); *Idaho ex rel. Soward v. United States*, 858 F.2d 445 (9th Cir. 1988) (McCarran-Ferguson Act does not apply), *cert. denied sub nom., Fagiano v. United States*, 490 U.S. 1065 (1989); *Gordon v. United States Dept. of Treasury*, 846 F.2d 272 (4th Cir. 1988) (McCarran-Ferguson Act does not apply), *cert. denied*, 488 U.S. 954 (1988). The recent opinions in these cases, particularly the Sixth Circuit's opinion in *Fabe*, 939 F.2d at 343-52, and the Ninth Circuit's opinion in *Soward*, 858 F.2d at 448-455, set forth thoroughly the various arguments on this unsettled question.

In *Soward*, the Ninth Circuit Court of Appeals found that the Federal Superpriority Act was violated by an Idaho insurance company liquidation statute which subordinated the priority of the IRS to that of policyholders. The Ninth Circuit carefully scrutinized three prior decisions of this Court which addressed the applicability of the McCarran-Ferguson Act, *Securities and Exchange Commission v. National Securities*. 393 U.S. 453 (1969), *Group Life & Health Insurance Company v. Royal Drug Company, Inc.*, 440 U.S. 205 (1979) and *Union Labor Life Insurance Co. v. Pireno*, 458 U.S. 119 (1982). In *Soward*, the Ninth Circuit Court of Appeals determined that *National Securities* controlled.

In *National Securities*, this Court was confronted with an Arizona statute aimed at protecting insurance company shareholders. This Court determined that the Arizona statute was outside the scope of the McCarran-Ferguson Act because the statute did not regulate the insurance relationship between the insurance company and its insureds, but rather the relationship between the insurance company and its shareholders. In *Soward*, the Ninth Circuit Court of Appeals, relying on the reasoning in *National Securities*, stated:

> The only 'business' being conducted is the liquidation of a corporation which happens to have been an insurance company. Hence, the scope of the net cast by the statute is wholly unrelated to the relationship between insurer and insured. The insurer has ceased to exist. The only relationship is between the insureds and the government official charged with overseeing the liquidation of the insolvents.

858 F.2d at 453.

Based on its analysis of this Court's decision in *National Securities*, the Ninth Circuit Court of Appeals in *Soward* held that the McCarran-Ferguson Act did not pre-empt the Federal Superpriority Act, because the Idaho insurance company liquidation statute did not regulate the "business of insurance."

In *dicta*, the *Soward* Court addressed both *Pireno*, 458 U.S. 119, and *Royal Drug*, 440 U.S. 205, two decisions of this Court which considered the issue of what constitutes the "business of insurance" under the McCarran-Ferguson Act. The court in *Soward* addressed each of the three factors identified in *Royal Drug* and summarized in *Pireno:*

> First, whether the practice has the effect of transferring or spreading a policyholder's risk; second, whether the practice is an integral part of the policy relationship between the insurer and the insured; and third, whether the practice is limited to entities within the insurance industry.

458 U.S. at 129.

First, the court in *Soward* stated that the first prong was not met because the Idaho statute's assignment of priority to some creditors as against other creditors does not "transfer" or "spread" policyholder risk. 858 F.2d at 454. Second, the court held that the Idaho liquidation statute does not meet the second prong of *Pireno* because it does not play an integral role in the insurer-insured policy relationship—"the insurer has ceased to exist by the time this statute comes into play." *Id.* Third, the court stated that the third prong was not met by the Idaho statutory liquidation statute because it affected the rights of all creditors, not just insurance companies. *Id. See, also, Gordon*, 846 F.2d at 273-74.

The Sixth Circuit in *Fabe* reached the opposite result. Since this Court has granted the Petition of Certiorari in *Fabe*, it would not be appropriate to detail the Sixth Circuit's holding in that case at this point of the proceedings. However, suffice to say that the Sixth Circuit was faced with precisely the same issue as the Court in *Soward*. After analyzing the Court's decisions in *National Securities*, *Soward* and *Pireno*, the Sixth Circuit addressed the issue of whether Ohio insurance company liquidation statutes met each of the three prongs of *Pireno*.

The court in *Fabe* stated that the first *Pireno* prong was met because the Ohio statute transferred the policyholders' risk of loss by insolvency of the insurer at the time the insurance policy contracts were entered into. 939 F.2d at 351.

Second, the court held that the second prong of *Pireno* was met because the state law is designed to protect the interests of insureds and their relationship with insurers. The Ohio statute provides policyholders with "assurances as to the reliability and enforcement of the policies issued." *Id.* Thus, the court held that the Ohio statute was an integral part of the relationship between the insurer and insured, satisfying the second prong of *Pireno.*

Third, the court found that the Ohio statute met the third prong of *Pireno*, which requires the scheme to be exclusive in its operation to entities within the insurance industry. The court stated that even though the liquidation of an insurance company involves non-policyholder creditors, the focus of the statute is "the protection of insureds by diverting the scarce resources of the liquidated entity away from any non-insured creditors, toward policyholders." *Id.* at 351-52.

This Court has decided to resolve the conflict between the McCarran-Ferguson Act and the Federal Superpriority Act, by granting certiorari in the *Fabe* case. The issue presented by this petition, the conflict between the McCarran-Ferguson Act and the Federal Arbitration Act, is a logical further step in resolving the conflict among the lower courts.

The Federal Superpriority Act deals with the determination of the priority of distribution of an insolvent insurance company's assets to various creditors, whereas the Federal Arbitration Act ensures that creditors who had the foresight to include arbitration clauses in their contracts will be able to enforce those clauses and have their disputes with insolvent insurance companies determined by arbitration. In other words, as applied in insurance company insolvency proceedings, both the Federal Superpriority Act and the Federal Arbitration Act deal with the resolution of disputes with an insolvent insurance company. Accordingly, a decision to review the Pennsylvania Supreme Court's ruling in this case would be wholly consistent with this Court's decision to review *Fabe*.

II. The Restriction of Contractual Rights by a Rehabilitation Plan, Which Does Not Provide Creditors With at Least What They Would Receive on Liquidation, Violates the Due Process Clause and the Contracts Clause.

In the *Neblett* case, this Court determined that a plan of rehabilitation under state law for an insolvent insurance company that did not provide creditors with at least what such creditors would receive upon liquidation of the insurer violates due process and impermissibly impairs such creditors' contractual rights. *Neblett v. Carpenter*, 305 U.S. 297, 305 (1938), *aff'g Carpenter v. Pacific Mut. Life Ins. Co.*, 74 P.2d 761 (Cal. 1937). Thus, if the Plan is to satisfy constitutional standards, it must provide Petitioner with at least what Petitioner would have received in a liquidation.

The Plan approved by the Pennsylvania courts did not do this. If the Mutual Fire proceedings had been a liquidation, 40 P.S. §221.32(a) would have governed. This statute provides that all mutual debts and mutual credits are to be "setoff and the balance only shall be allowed or paid. . . ." There are no restrictions in the calculation of setoff other than a restriction on offsetting premiums owed the insolvent insurance company. Thus, if this case had been a liquidation, Petitioner could have setoff all mutual debts, with any balance in favor of Petitioner being assertable as a Claim.

However, the Plan severely restricts Petitioner's contractual right of setoff primarily, but not exclusively, by limiting the types of claims that can be used in calculating the setoff and restricting the time periods for

the calculation of setoff.[8] In a liquidation, Petitioner would be permitted to offset significantly more of its obligations (other than premiums) that it owed Mutual Fire. The restrictions on setoff under the Plan are impermissible under *Neblett*.

Similarly, the treatment by the Plan of Petitioner's secured creditor rights is significantly less favorable than would have been the case under a liquidation (Pet. App. A91). Under Pennsylvania law, in a liquidation Petitioner would have been entitled to receive all of its collateral for the full amount of its secured claim, with any deficiency being treated as an unsecured claim. For example, Mutual Fire could not have enjoined any attempt by Petitioner to draw down on letters of credit issued by financial institutions for Petitioner's benefit to secure Mutual Fire's obligations to Petitioner. 13 P.S. §5114. Conversely, the Plan restricts Petitioner's rights to draw on its collateral only to those draws related to paid losses and paid loss adjustment expenses. Moreover, the Plan requires Petitioner to obtain the Commissioner's approval before realizing on its secured collateral, a further restriction which would not have been imposed under a liquidation.

These issues are litigated often, and guidance by this Court would go far toward settling the commercial expectations in this major U.S. industry. This is sufficient reason for this Court to grant this petition. Another reason involves the Pennsylvania Supreme Court's refusal to apply this Court's constitutional standards as announced in the *Neblett* case.

[8] For a discussion on the limitations on setoff contained in the Plan, see footnote 5.

In discussing the objecting parties' assertions that the Plan impermissibly impaired their various contractual rights, the Court relied on *dicta* in *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*, 459 U.S. 400 (1983), that contract rights can be impaired by state law if the state is prompted by a significant and legitimate state interest.

The Pennsylvania Supreme Court's reliance on *Energy Reserves* is misplaced. In that case, this Court based its decision on the fact that the contracting party "knew its contractual rights were subject to alteration by state price regulation." *Id.* at 416. The contracting party in *Energy Reserves* knew at the time it entered into the contract that the state might pass laws which would cap the prices it could charge under a contract with a utility company. Justice Powell pointed out in his concurring opinion that the majority decision was based on the fact that the contracting parties' reasonable expectations were not "impaired" by the Kansas statute. *Id.* at 421.

That is not the case here. The legitimate expectation of the Petitioner when it entered into the contracts with Mutual Fire was that its setoff rights and rights in and to its collateral would be allowed as such rights existed under the state statutes and would be so preserved by the Pennsylvania courts. At that time, there were no extant cases or statutes that had previously denied or limited setoff rights of reinsurers or that had previously denied or limited rights of secured reinsurers to their collateral. The Plan constituted a sudden and unanticipated retroactive modification of the existing rights of Petitioner which is not permitted at law. *Right Structural Steel Co. v. Spannaus*, 438 U.S. 234 (1978). Under *Neblett*, Petitioner was entitled to its

bargained-for rights to the extent it would have received them under liquidation. The Plan substantially, adversely and impermissibly affected those rights.

Moreover, the *dicta* in *Energy Reserves* relied upon by the Pennsylvania Supreme Court is inapposite. In *Energy Reserves*, this Court stated that contracts can be impaired by state law if the state has a "significant and legitimate state interest" in doing so. 459 U.S. at 416. The Court held that the Kansas statute regulating the price of natural gas intrastate is a significant and legitimate state interest. However, restricting contractual rights of creditors of a defunct insurance company is not the regulation of a significant and legitimate state interest. A defunct insurance company is not part of the insurance industry. The only interests left to consider are the interests of creditors.

As stated in the prior section, the liquidation (either under the Plan or by straight liquidation) is not the "business of insurance" under the McCarran-Ferguson Act and does not constitute the type of significant and legitimate state interest as does the regulation of the price of natural gas. The right to regulate the price of gas overrides the rights of individuals to the benefit of their contracts under the Contracts Clause. Conversely, the rights of creditors of a defunct insurance company should not be the subject of state action to prefer policyholders over other creditors if doing so would impair the contract rights of those creditors. Thus, the *dicta* in *Energy Resources* should not have been relied upon by the lower court.

Moreover, *Energy Resources* does not address the due process clause. In *Neblett*, this Court held that a rehabilitation plan had to provide the creditor with the same property that such creditor would have received under a liquidation. *Energy Resources* did not address the issue of the taking of property. In the case at bar, Petitioner's right to its collateral and its right to setoff have been restricted severely by the Plan. Both of these property rights are protected under the Due Process Clause. While *Neblett* directly deals with that particular issue, *Energy Resources* does not. The Pennsylvania Supreme Court should have relied on *Neblett* in determining whether Petitioner's rights were violated in violation of the United States Constitution.

CONCLUSION

Petitioner respectfully requests the Court to grant this petition for a writ of certiorari for the reasons stated above.

Respectfully submitted,

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APPENDIX

APPENDIX

OPINION OF THE SUPREME COURT OF PENNSYLVANIA

(Decided August 21, 1992)

IN THE SUPREME COURT OF PENNSYLVANIA

Constance B. FOSTER, Insurance Commissioner of the Commonwealth of Pennsylvania

v.

The MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY.
Appeal of COMMITTEE OF POLICYHOLDERS at Nos. 28/71 1989.
Appeal of COLONIAL PENN GROUP, INC. AT No. 15/90.
Appeal of ALLSTATE INSURANCE COMPANY at No. 16/90.
Appeal of AIG RISK MANAGEMENT et al. at No. 17/90.
Appeal of PEPSI-COLA BOTTLING CO. OF CHARLOTTE, INC., et al. at No. 18/90.
Appeal of FIREMAN'S FUND INSURANCE CO. and Interstate Fire and Casualty Co. at No. 19/90.
Appeal of COMMITTEE OF POLICYHOLDERS at No. 20/90.
Appeal of EVANSTON INSURANCE CO. at No. 21/90.
Appeal of RLI INSURANCE CO. at No. 22/90.

Appeal of PA. INSURANCE GUARANTY ASSN. (PIGA) at No. 23/90.
Appeal of The MEMBER COMPANIES OF the REPUBLIC INSURANCE GROUP, et al. at No. 24/90.

132 Pa. Commw. Ct. 196
572 A.2d 798 (1990)

ARGUED: May 8, 1990
DECIDED: August 21, 1992

OPINION

NIX, *C.J.*

This is an appeal from the order of the Commonwealth Court modifying, and then approving, a Rehabilitation Plan ("Plan") for Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire") submitted by Appellee, Constance Foster, Insurance Commissioner of the Commonwealth of Pennsylvania ("Commissioner or Rehabilitator"), pursuant to Section 515(a) of Article V of the Act of May 17, 1921, P.L. 789, *as amended*, by the Act of December 14, 1977, P.L. 280, 40 P.S. §221.15 (known as the Insurance Department Act of 1921). While numerous Appellants challenge the Plan on multiple and varying grounds, the threshold issue to be resolved is whether the Plan as submitted legally represents a legitimate plan of Rehabilitation or whether the Plan, in reality, is a *de facto* liquidation plan, filed by the Rehabilitator lacking any rehabilitative purpose, thus constituting an abuse of her discretion. Should this Court find that the proposed Plan represents a liquidation instead, the numerous appeals herein, which challenge specific provisions of the Plan of rehabilitation, would be rendered moot.

FACTS

The facts, as presented in the opinion of the Commonwealth Court, have been adopted and incorporated for our purposes herein.

In December 1986, George F. Grode, then Commonwealth Insurance Commissioner, sought, with the consent of Mutual Fire's officers and directors, appointment as Rehabilitator or Mutual Fire, Section 515(a) of the Act, 40 P.S. §221.15(a), and submitted a rehabilitation plan. Prior to this petition, Commissioner Grode had placed Mutual Fire under his supervision. Section 510(d) of the Act, 40 P.S. §221.10(d). At the time the petition was filed, Mutual Fire reported assets of $99.4 million and total liabilities of $260.1 million, with a negative policyholders' surplus of nearly $161 million.

When it became apparent to the Commonwealth Court that adequate notice had not been given to policyholders and other creditors on whom the original plan would have a direct and substantial impact, hearing on the Plan's approval was continued generally. At the same time, the Court directed the Insurance Department to prepare a notice of hearing to be sent to all known policyholders and creditors indicating the procedure for obtaining the plan and raising objections prior to a Court hearing on its approval. Thereafter, many objections were made. These objections were drawn from individual policyholders, claimants against policyholders, reinsurers doing business with Mutual Fire, creditors and agents of Mutual Fire.

In early 1987, upon application of several policyholders, also objectors to the plan, the Commonwealth Court formed a Committee of

Policyholders (Policyholders Committee), whose purpose was to "consult with the statutory rehabilitator on the administration of this matter and advise those represented as to the proposed plan." The Commonwealth Court formed the Policyholders Committee with the express intent of assuring that policyholders *first and foremost* suffered the least amount of harm resulting from the unfortunate series of events culminating in this insurance company's reorganization effort.

The Rehabilitator, now Commissioner Foster, thereafter filed her responses to the objections to the proposed rehabilitation plan. The Policyholders Committee and numerous other parties strenuously objected to this proposed plan on the grounds, *inter alia*, that the Rehabilitator had released no financial information or documentation to substantiate the projections of 100% payment to policyholders contained therein. Hence, the court ordered the Rehabilitator to allow the Policyholders Committee and all interested persons access to Mutual Fire's books and records. A hearing date was then set for June 3, 1987.

At that hearing, various stipulations by and among the objecting parties (including the Policyholders Committee) were entered. The proposed plan was approved, subject to those stipulations, which altered it materially but in a manner not pertinent to this discussion.

Several months later, the Rehabilitator, pursuant to the court's Order approving the proposed plan, filed a report on the progress of the rehabilitation for the period

from December 8, 1986 (the date on which the statutory Rehabilitator was appointed) to October 26, 1987. At the same time, the Rehabilitator sought additional time to evaluate the feasibility of its implementation. The court granted the Rehabilitator's request for additional time and directed her to submit to the court a schedule of tasks to be performed in order to complete the evaluation. Among these tasks were the engagement of litigation counsel to investigate possible causes of action by the Rehabilitator on behalf of Mutual Fire, Section 516(c) of the Act, 40 P.S. §221.16(c); the appointment of a professional firm to perform actuarial analyses of Mutual Fire's loss reserves; and the engagement of auditing and claims settlement services, Section 516(b) of the Act, 40 P.S. §221.16(b). At that time, the Rehabilitator opposed the Policyholders Committee's motion to appoint an independent manager to oversee the rehabilitation on site.

On May 2, 1988, the Rehabilitator filed her report on the feasibility of implementing the amended plan approved June 26, 1987. After close consultation, pursuant to Section 515(c) of the Act, 40 P.S. §221.15(c), the court and Commissioner Foster determined that any viable rehabilitation of this magnitude would necessarily demand sufficient legal, managerial, financial and technical resources. It was therefore decided that initially a deputy rehabilitator would be appointed, Section 516(a) of the Act, 40 P.S. §221.16(a), and legal counsel would be retained to investigate possible sources of recovery through litigation where litigation was deemed fruitful to collect the recoverables comprising a significant portion of this estate's assets.

On June 1, 1988, having reviewed the Rehabilitator's report on Plan implementation, which indicated the 1987 Plan was not feasible for several reasons, the court directed the Rehabilitator to submit a modified plan. The plan was to include a provision to trigger applicable state insurance guarantee funds (both in Pennsylvania and other states) and a provision for proportionate periodic payments of policyholders' claims. Additional counsel was hired to assist the Rehabilitator in formulating a modified plan.

Thereafter, the Rehabilitator applied to the Commonwealth Court for approval to suspend payment of certain loss adjustment expenses incurred under Mutual Fire's obligations to defend its insureds. The Rehabilitator also asked the court for a determination that Mutual Fire was insolvent.

The Rehabilitator submitted a new Plan of Rehabilitation on January 31, 1989. After notice was issued to policyholders and all known creditors and was published in periodicals of general and industry circulation, numerous objections were filed. The Commonwealth Court, over the course of four days, heard testimony and argument in support of and against certain provisions of the Plan. The Commonwealth Court (Crumlish, P.J.) approved the Plan with certain modifications, and the instant appeal followed.

The Appellants in this matter are several insurance companies, policyholders and other creditors who have claims against Mutual Fire or other financial interests in the disposition of the company's assets. Specifically, the insurance companies are engaged in reinsurance or cedent[1] relationships with Mutual Fire, and the

[1] Cedents are those companies whom Mutual Fire reinsures. Plan of Rehabilitation, Section I(4).

Committee of Policyholders, which has appeals at Nos. 20, 28 and 71, represents policyholders whose outstanding claims with Mutual Fire have yet to be paid.

SCOPE OF REVIEW

The General Assembly, in recognition of the specialized complexities involved in insurance generally, and in the regulation of this industry in particular, assigned the task of overseeing the management of that industry, in this Commonwealth, to the Insurance Department, the agency having expertise in that field. 40 P.S. §41, *et seq.* The Insurance Commissioner, an appointed position pursuant to 40 P.S. §42 is, therefore, afforded broad supervisory powers to regulate the insurance business in this Commonwealth, including the power to protect "the interests of insureds, creditors, and the public generally . . . ." 40 P.S. §221.1(c). Accordingly, the delegation of such caretaking authority necessarily includes exercising a direct role in the rehabilitation of insolvent insurers. Subsection (c) of Section 515 of the Insurance Act, 40 P.S. §221.15, authorizes the Insurance Commissioner in her capacity as Rehabilitator "to take possession of the assets of the insurer . . . and to administer them under the orders of the court."

Upon petition by the Commissioner to the Commonwealth Court for an Order authorizing him or her to rehabilitate an insurer pursuant to 40 P.S. §221.15(a) and once such a rehabilitation plan has been ordered, the Rehabilitator is charged to "take such action as [s]he deems necessary or expedient to correct the condition or conditions which constituted the grounds for the order of the court to rehabilitate the insurer." 40 P.S. §221.16(b). This mandate explicitly defers all actions to the skill of

the Rehabilitator and implicitly recognizes her expertise in these matters. Additionally, the Rehabilitator is granted the power to retain those persons necessary to assist in the rehabilitation process. 40 P.S. §221.16(a) ("Powers and Duties of the Rehabilitator").

Once the Insurance Commissioner and her deputies have designed a plan of rehabilitation it must be submitted to the Commonwealth Court for approval in order that it may have efficacy. The Commonwealth Court is empowered by the General Assembly to supervise and review the activities and proposals of the Insurance Commissioner while she undertakes the rehabilitation of an insolvent insurer. 40 P.S. §221.4(a); 42 P.S. §761(a)(3). In overseeing the course of rehabilitation to check any abuse of discretion by the Commissioner, the Commonwealth Court is authorized to "approve or disapprove the plan [of rehabilitation] proposed, or may modify it and approve it as modified. If it is approved, the rehabilitator shall carry out the plan." 40 P.S. §221.16(d). Therefore, in order for the Plan to warrant the Commonwealth Court's imprimatur it must be found to be free from any abuse of the Rehabilitator's discretion.

Instantly, the Rehabilitator recommended a final, amended Plan of Rehabilitation to the Commonwealth Court on January 31, 1989. The group of policyholders designated to represent many creditors of Mutual Fire were notified of the specifics of the Plan and numerous objections were filed. After hearing several days of testimony and argument the Commonwealth Court approved the Plan with certain modifications by Order dated January 23, 1990, and we now address those objections raised against the Plan.

As is evident from the above referenced statutory provisions, both the Insurance Commissioner and the Commonwealth Court are obligated to interact in order to supervise, implement and regulate equitably the process engaged to rehabilitate an insolvent or financially hazardous insurer. As a result of these specific assignments, it is not the function of the courts to reassess the determinations of fact and public policy made by the Rehabilitator. Rather, the involvement of the judicial process is limited to the safeguarding of the plan from any potential abuse of the Rehabilitator's discretion. In summarizing the law of this Commonwealth concerning judicial review of the determinations made by administrative agencies, we have stated:

> 'It has been established as an elementary principle of law that courts will not review the actions of governmental bodies or administrative tribunals involving acts of discretion *in the absence of bad faith, fraud, capricious action or abuse of power* . . . . That the court might have a different opinion or judgment in regard to the action of the agency is not a sufficient ground for interference; *judicial* discretion may not be substituted for *administative* discretion.'

Norfolk & Western Railway Co. v. Pennsylvania Public Utility Comm., 489 Pa. 109, 128, 413 A.2d 1037, 1047 (1980) (quoting *Blumenschein v. Housing Authority*, 379 Pa. 566, 573, 109 A.2d 331, 334-35 (1954)) (emphasis added). This basic jurisprudential tenet was recently and emphatically reaffirmed by this Court in *Slawek v. Commonwealth, State Bd. of Medical Educ. and Licensure*, 526 Pa. 316, 586 A.2d 362 (1991).

It is axiomatic, therefore, that judicial discretion is not to be substituted for administrative discretion. We reaffirm *Norfolk* as the standard for determining whether or not the Insurance Commissioner abused her discretion in formulating the Plan of Rehabilitation. Upon application of the test, should the Commonwealth Court find such an abuse of discretion under the *Norfolk* standard, the Commonwealth Court is limited, by statute, to preventing any further abuse of discretion by either rejecting the plan or modifying the plan and then approving it as modified. 40 P.S. §221.16(d).

Ordinarily, this Court's review of the Commonwealth Court's actions would be consistent with the traditional appellate review of judicial discretion exercised in a judicial proceeding which is limited to determining questions of law and whether sufficient competent evidence exists to support the exercise of discretion engaged below, as enunciated in *Ben Avon Boro. v. Ohio Valley Water Co.*, 271 Pa. 346, 114 A. 369 (1921). However, instantly we are reviewing judicial discretion exercised in an area dedicated to the expertise of a given administrative agency, the guidelines for such review of which have been narrowly and specifically stated in *Norfolk, supra.* Therefore, upon review of the Commonwealth Court's discretion, our review must be equally specific and limited in order to remain consistent with the principles of *Norfolk* that restrict judicial discretion to those instances where the agency has abused its discretion.

Accordingly, in order to make a reasonable evaluation of the Commonwealth Court's review of administrative agency activity, in keeping with the principles of *Norfolk*, we adopt the following three part standard: (1) examination of whether the Commonwealth

Court exceeded its statutory authority to approve, disapprove or modify the rehabilitation plan; (2) determine whether the Commonwealth Court substituted any of its own beliefs into the rehabilitation process; and (3) if so, whether the exercise of such discretion was for the prevention of further abuse by the Rehabilitator, and not to change the substance of the plan. Instantly, this limited scope of review is especially appropriate in a highly specialized industry such as insurance, where the skill, judgment and expertise of the Insurance Commissioner are statutorily recognized and deferred to, resulting in a broad scope of discretionary powers.

Numerous other jurisdictions in this country have also held that the decision of a Rehabilitator to rehabilitate the insolvent business of an insurer is within the sound discretion of the rehabilitator and should not be rejected by the reviewing court unless the Rehabilitator has abused that discretion. *Kueckelhan v. Federal Old Line Insurance Co.*, 74 Wash. 2d 304, 444 P.2d 667 (1968); *Carpenter v. Pacific Mutual Life Insurance Co.*, 10 Cal. 2d 307, 74 P.2d 761 (1937), *aff'd sub nom. Neblett v. Carpenter*, 305 U.S. 297 (1938).

In *Kueckelhan*, the applicable statute involved, Wash. Rev. Code §48.31.040 (1989), has provisions very similar to the applicable Pennsylvania statutes.[2] There, the Rehabilitator is also directed to take possession of the assets of the insurer and to conduct the business thereof with the goal of removing the causes and conditions which made the rehabilitation necessary. In

[2] Due to these similarities between the applicable statute in *Kueckelhan* and the statutes governing insurance rehabilitation in this Commonwealth, we find the rationale of the Washington Supreme Court to be persuasive.

discussing the role of the courts vis-a-vis the rehabilitative conduct of an Insurance Commissioner, the *Kueckelhan* court stated:

> The courts cannot dictate or outline the general policy or course of conduct of the Insurance Commissioner or his department . . . , because this outline is dependent on the terms of the applicable statutory provisions and not upon judicial discretion. Our statutory provisions, therefore, properly place the responsibility on both the Insurance Commissioner and the courts, the Commissioner being required to follow the statutory mandates and to use reasonable discretion in the rehabilitation of a seized company, *with abuses of discretion to be checked by the judiciary.*

Kueckelhan, 74 Wash. 2d at _____, 444 P.2d at 674 (emphasis added) (citations omitted). The court in *Kueckelhan* added:

> "Toward this end [the Insurance Commissioner] must be afforded that freedom of action in the overall management of the company which will permit him to knowledgeably evaluate, plan, devise, and implement a program which in his best judgment and in keeping with his expertise in the field of insurance will accomplish the objective of the proceeding."

Id.

This Court has concluded that this great deference in favor of the Insurance Commissioner and the resulting narrow scope of review for the courts are in recognition of the expertise of the administrative agency or individual officer assigned the task of regulating a given industry. *See, e.g., Mathies Coal Co. v. Commonwealth, Department of Environmental Resources*, 522 Pa. 7, 559 A.2d 506 (1989); *Brocal Corporation v. Commonwealth, Department of Transportation*, 515 Pa. 224, 528 A.2d 114

(1987); *Pelton v. Commonwealth, Department of Public Welfare*, 514 Pa. 323, 523 A.2d 1104 (1987); *Pennsylvania Bankers Ass'n v. Secretary of Banking*, 481 Pa. 332, 392 A.2d 1319 (1978). Instantly, as the Plan *sub judice*, as modified, was a considered exercise of judgment on behalf of the Insurance Commissioner in her capacity as Rehabilitator and as it was thoroughly supervised and implemented with the capable assistance of the Commonwealth Court, as provided by statute, we cannot interfere with those findings or determinations made below, absent an abuse of discretion. Accordingly, for the reasons that follow, we believe the Plan of Rehabilitation, as modified by the Commonwealth Court, is a legitimate and proper exercise of the Rehabilitator's statutory powers, and properly effectuates the intentions of the rehabilitation statutes. We, therefore, with the exception of an additional modification to Section XVII of the Plan ("Interest"), affirm the Order of the Commonwealth Court.[3]

REHABILITATION v. LIQUIDATION

Appellant Allstate challenges the Plan on the basis that it more properly represents a liquidation plan and as such, it has been improperly implemented under the Rehabilitation portion of the Insurance Act. It is argued that the instant plan does not contemplate a resuscitation of Mutual Fire's operations which is one of the stated purposes of the rehabilitation statute. Further, opponents of the Plan claim it is in violation of *Neblett v. Carpenter*, 305 U.S. 297 (1938), in which the United States Supreme Court held that a rehabilitation

[3] We restrict our review to only those issues properly raised before, and addressed by, the Commonwealth Court. Those issues now sought to be resolved which were not raised in the Commonwealth Court are deemed to have been waived. *See* Pa. R.A.P. 302(a).

plan cannot impose harsher consequences than a liquidation. Under *Neblett*, creditors must fare at least as well under a rehabilitation plan as they would under a liquidation, which Appellants currently argue, would not be the case under this Plan. We disagree and affirm the finding of the Commonwealth Court that this plan properly effectuates the goals of rehabilitation embodied in 40 P.S. §221.14 *et seq.*

The Commonwealth Court correctly concluded that the ultimate goal of the plan *is* to have Mutual Fire reemerge as a solvent insurer. The Plan calls for Mutual Fire's possible restructure and orders that it maintain its required capital and surplus minimums required in order to resume operations in the future.

The rehabilitation, in order to be legitimate, does not have to restore the company to its exact original condition. So long as the rehabilitation properly conserves and equitably administers "the assets of the involved corporation in the interest of investors, the public and others, (with) the main purpose being the public good" the plan of rehabilitation is appropriate. 2A *Couch on Insurance* 2d §22.10. The Plan as it presently appears before this Court does provide the benefits of rehabilitation such as flexibility and the accelerated disposition of claims which the Commonwealth Court properly recognized as preferable to and distinct from, the ordinary procedures of liquidation. The Commonwealth Court after an extensive and thorough analysis concluded that the plan of rehabilitation best effectuates the "legislatively stated purpose (of) 'the protection of the interest of insureds, creditors and the public generally . . . .' and the 'equitable apportionment of any unavoidable loss' through *inter alia*, 'improved methods for rehabilitating insurers . . . ,' Section 501 of

the Act, 40 P.S. §221.1." *Grode v. Mutual Fire, Marine and Inland Insurance Company*, 132 Pa. Commw. Ct. 196, 207, 572 A.2d 798, 803 (1990) (quoting 40 P.S. §221.1(c)).

Finding no meritorious challenge to the Plan on this issue, and in recognition of the validity of the goals sought and the scheme offered by the rehabilitation, we affirm the Commonwealth Court's holding that this is a legitimate plan of rehabilitation intended for the benefit of the public and not a *de facto* plan of liquidation.

In keeping with our limited and narrow scope of review we will now address *seriatim* the remaining issues raised before and resolved by the Commonwealth Court.

IMPAIRMENT OF CONTRACTUAL RIGHTS

Several objectors to the plan assert that the Plan as proposed impermissibly impairs their various contractual rights. While this may in fact be an accurate assessment of the consequence of the proposed rehabilitation, such impairment is not a *per se* violation of law and we agree with the Commonwealth Court that any actual impairments are insubstantial.

Again, we must look to the broad powers afforded to the Commissioner granted in order to effectuate equitably the intent of the Rehabilitation statutes, i.e., to minimize the harm to *all* affected parties. As such, she has a fiduciary duty to marshall and preserve all assets of the insolvent entity. Furthermore, the exigencies attendant to a major commercial insolvency and the goals of rehabilitation necessitate the reality that "individual interests may need to be compromised in order to avoid greater harm to a broader spectrum of policyholders and the public." *Vickodil v. Commonwealth, Insurance Department*, 126 Pa. Commw.

Ct. 390, 396-97, 559 A.2d 1010, 1013 (1989). *See also Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400, 103 S. Ct. 697, 74 L. Ed. 2d 569 (1983).[4]

[4] Several Appellants, including the Member Companies of the Republic Group, 24 M.D. App. Dkt. 1990, allege that the setoff provisions impermissibly violate the impairment of contract provisions of both Art. I, §10 of the United States Constitution and Art. I, §17 of the Pennsylvania Constitution. In determining when state law may repair a contractual right, the United States Supreme Court in *Energy Reserves Group, Inc. v. Kansas Power and Light*, 459 U.S. 400 (1983), established a three-part test. The threshold inquiry is to determine whether the state statute in reality has operated to substantially impair a contractual relationship. *Id.* at 411. Should it be determined that a substantial impairment has occurred, the state must set forth a legitimate and significant public purpose. *Id* at 412-13. Once that purpose is identified, the final inquiry concerns whether the adjustment of contractual rights is reasonable and of a nature appropriate to the public purpose justifying the legislation's adoption; however, if the state is not a contracting party, deference is given to the state's enunciated purpose. *Id.*

We agree with the Rehabilitator that the instant Plan satisfies this test. The Commonwealth Court properly upheld this portion of the Plan and concluded that in order to achieve the desired consequence of satisfying all claims in an equitable and orderly manner the resulting alleged contract impairments were insubstantial. Furthermore, the significant interest on behalf of the state to regulate the fiscal affairs of its insurers for the welfare of the public would still render the Plan permissible should impairment be found to exist. It is also worthy to note that the objectors to the Plan are members of a highly regulated industry and as such were well aware of the powers of a Rehabilitator. Accordingly, the Commonwealth Court properly dismissed Appellants' challenge to the setoff provision of the Plan under the federal constitution. As our impairment of contract provision, Art. I, §17 of the Pennsylvania Constitution, mirrors that of the United States Constitution, we are guided by the United States Supreme Courts' analysis in *Energy Reserves v. Kansas Power & Light*. Therefore, we adopt the same test instantly and likewise dismiss the impairment of contract challenge made under the Pennsylvania Constitution.

Thus, the action of the Rehabilitator fosters the legitimate public purpose of safeguarding the public interest from the potentially innumerable consequences of Mutual Fire's insolvency. Accordingly, we find no error or abuse of discretion with this portion of the Plan as it is legitimately designed to ameliorate a financial hazard for the good of all involved. We, therefore, affirm this portion of the Order of the Commonwealth Court.[5]

SETOFF

Next, review of the Plan's setoff provisions requires a three-tiered analysis, as the provisions affect several groups of interested parties differently. Pursuant to the Insurance Act "[M]utual debts or mutual credits between the insurer and another person in connection with any action or proceeding under this article shall be set off and the balance only shall be allowed or paid . . . ." 40 P.S. §221.32(a). This option was immediately challenged as this statutory provision allowing for setoff appears only under the liquidation portion of the Insurance Act, and thus it is argued cannot apply in support of the alleged plan of rehabilitation. As the Commonwealth Court correctly observed, this distinction "evidences an intent that rehabilitation proceedings are distinct from liquidation proceedings." *Grode v. Mutual Fire, Marine & Inland Insurance Co.*, 132 Pa. Commw. Ct. 196, 211, 572 A.2d 798, 805 (1990).

[5] The Commonwealth Court made minor adjustments, extractions and modifications to certain provisions of the Plan, including modifications later in the Plan concerning the allegation of contractual impairment discussed above. We will address these modifications later in the opinion at the appropriate time and place. It is to be noted, however, that most of the modifications to the Plan worked to mitigate certain objections of Appellants and as such they are appropriate.

However, should the plan of rehabilitation as proposed offer significant benefits in serving the public interest, the discretionary action of the Rehabilitator should be approved absent any arbitrary or manifest abuse of discretion. Furthermore, while Pennsylvania common law has long recognized and permitted the concept of setoffs, *Dickerson v. Dickersons Overseas Company*, 369 Pa. 244, 85 A.2d 102 (1952); *In re Kenin's Estate*, 346 Pa. 127, 29 A.2d 495 (1943), their application is not mandatory. Rather, the common law right to setoff, a form of contractual impairment, is an equitable right to be permitted solely within the sound discretion of the court. *In Re Bell*, 147 Pa. Super. 471, 24 A.2d 101 (1942); *Abrahams v. Wilson*, 134 Pa. Super. 297, 3 A.2d 1016 (1939); *Commonwealth ex rel. Sheppard v. Central Penn National Bank*, 31 Pa. Commw. Ct. 190, 375 A.2d 874 (1977).

The second point of contention is raised by Mutual Fire's reinsurers alleging that the Plan improperly includes a provision prohibiting any setoff of *premium obligations due Mutual Fire.* This argument is without merit and was properly rejected by the Commonwealth Court. Existing law, in plain words, expressly forbids a setoff of premium obligations. 40 P.S. §221.32(b)(4) states in relevant part:

> (b) *No setoff* or counterclaim shall be *allowed* in favor of any person *where*:
>
> > (4) *the obligation of the person is to pay premiums*, whether earned or unearned, to the insurer.

40 P.S. §221.32(b)(4) (emphasis added). This *express* prohibition, however, appears only in the liquidation portion of the Insurance Act. Appellants argue that since the sole location of the premium setoff prohibition

is in the liquidation section, this precludes its application in a rehabilitation context. However, they fail to recognize the fundamental language of 40 P.S. §221.32(a). That section begins by stating that the setoff provisions *apply to any action or proceeding "under this article."* 40 P.S. §221.32(a) (emphasis added). Since the term "this article" refers to Article V of the Act of May 17, 1921, P.L. 789, *as amended*, by the Act of Dec. 14, 1977, P.L. 280, 40 P.S. §221.1 *et seq.* which encompasses both the sections on liquidation *and* rehabilitation, the relevant provisions regarding setoffs under the liquidation section must also apply to actions proceeding under the statutory rehabilitation provisions. Additionally, the provision of the Plan expressly prohibiting a premium setoff in a *rehabilitation* context, ensures that the creditors herein, at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding as mandated by the holding of *Neblett, supra.*

The goal of rehabilitation is to manage the affairs of an insolvent insurer with the intended result of restoring the entity to sound fiscal status. Instantly, it is essential that all assets flowing into the rehabilitated entity be treated preferentially in order that the insurer have an opportunity to remain afloat and survive. The statute involved implicitly recognizes this necessity to maintain and protect an insurer's principal asset, premiums due, from premature extinguishment. Therefore, the provision of the Plan denying premium setoffs is unquestionably valid and legitimately exercises the Rehabilitator's statutory powers, and thus, will properly remain undisturbed.

Next, various objectors to the Plan challenge the two definitions of setoff offered by the Plan. The first definition, referred to by some Appellants as the "basic

setoff definition" or "mandatory setoff definition", provides that: "[S]etoff for purposes of this Plan shall be calculated as of December 4, 1986.[6] Balances set forth on the books of Mutual Fire shall be conclusive." The only mutual debts and credits that may be setoff against one another are those "Due and Owing[7] on December 31, 1986." *Plan of Rehabilitation* at 14. Objectors complain because this definition, limiting setoff to only those debts which are mutual, due and owing, prohibits the application of case reserves and incurred but not reported ("IBNR") claims.

The second definition under the Plan, referred to as the "optional setoff definition", provides:

> E. Election of Optional Setoff Definition
>
> 1. Election. A Reinsurer who is also a Cedent may pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan, in which event the Optional Setoff Definition set forth below shall apply to said Reinsurer. Balances set forth on the books of Mutual Fire shall be conclusive for this purpose.
>
> 2. *Optional Setoff Definition.* The Optional Setoff Definition shall be as follows:

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[6] As originally submitted, this provision of the Plan had provided for a December 31, 1986 calculation date. This date was modified by President Judge Crumlish of the Commonwealth Court as part of his Order, modifying and approving the Plan as modified. This modification was ordered to preserve the fundamental right of the creditors to be treated, at a minimum, as well under the rehabilitation as they would in a liquidation.

[7] The term "Due and Owing" is defined in Section I of the Plan as "Reinsurance recoverable on paid losses, paid Loss Adjustment Expenses, Claim Settlements and reimbursement agreements." Plan at 2.

Any Reinsurer of Mutual Fire who is also a Cedent to the Mutual Fire will be permitted to setoff the lesser of Mutual Fire's obligations to the Cedent against the Reinsurer's obligations to Mutual Fire according to Mutual Fire s books pursuant to the following calculation:

Option Setoff Calculation[8]—The lesser of:

a. Mutual Fire's obligation to the Cedent for:

balances Due and Owing, plus reported Case Reserves, plus reported IBNR.[9]

All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire for:

balances Due and Owing, plus Case Reserves. All as computed as of December 4, 1986.

[8] As President Judge Crumlish stated in his opinion concerning his modification of Section III, E.2.a of the Plan, pertaining to reinsurers who are also Cedents:

> "... [that Section] shall read so as to compute balance as of December 4, 1986, the date on which the Commissioner filed the petition for rehabilitation. Had the Commissioner petitioned for liquidation rather than rehabilitation on that date, these objector's rights would be fixed as of that filing date. Section 520(d) of the Act, 40 P.S. §221.20(d). Thus, this Plan modification assures that those objectors receive substantially the same set off rights and treatments they would receive in a liquidation."

Grode v. Mutual Fire, Marine and Inland Insurance Co., 132 Pa. Commw. Ct. 196, 211, 572 A.2d 798, 805 (1990).

[9] These terms were defined by Appellee, Insurance Commissioner as follows:

> "Case reserves are estimates of amounts required to cover future payments on account of known claims. IBNR refers to amounts predicted to be paid in the future on account of events that have occurred but have not been reported as claims to the insurer.

Appellees Brief at 58 fn. 8.

The reinsurers again object, claiming the optional definition of setoff also fails to allow them to setoff their IBNR obligations to Mutual Fire that had not matured on the date of rehabilitation. Conversely, in support of the Plan's setoff provision and the modification made by the Commonwealth Court concerning the cut off date, the Insurance Commissioner argues: "[I]n so defining setoff, the Plan has given appropriate recognition to the traditional equitable remedy of setoff while limiting it to its appropriate scope by imposing the requirement that only matured, liquidated obligations may be setoff." Brief of Appellee at 57.

While the objections that the Plan effectively denies Appellants their right to setoff obligations to Mutual Fire that had not matured as of the time it went into rehabilitation is appealing on the surface, it bears repeating that it is a fundamental principle of Pennsylvania law that setoff is an equitable remedy and accordingly, is permissive, not mandatory. *In Re Bell, supra.* Furthermore, no right of setoff can be available against a note or other obligation that does not mature until after a receiver for the insolvent debtor is appointed. *Commonwealth ex rel. Bell v. Trademen's Trust Co.*, 250 Pa. 372, 95 A. 574 (1915). *Accord Appeal of Commonwealth Trust Co. of Pittsburgh*, 324 Pa. 161, 188 A. 200 (1936).

Instantly, we find this analysis especially compelling as case reserves are not present obligations of the reinsurer. Case reserves and IBNR are at most calculations or estimates of future potential liabilities, which often times are contingent upon a later development or growth of the claim or some intervening procedure such as litigation. Their speculative and

intangible nature at the time of the petition of rehabilitation does not warrant their being available for setoff against more due and owing or mature obligations.

Assuming *arguendo*, however, that a case was established to support the applicability of case reserves and IBNR to setoff, this does not necessarily automatically create such an entitlement. Once again, it is fundamental that setoff is an equitable remedy within the sound discretion of the Rehabilitator and/or the trial court and absent an abuse of that discretion reviewing courts must refrain from involvement. In keeping with the stated intent of rehabilitation to protect and preserve the estate of the insolvent insurer for the benefit of *all* creditors, we find no error or abuse in denying the reinsurers the windfall which would result from allowing the reinsurer to offset obligations against Mutual Fire that had not matured as of the time the petition for rehabilitation was filed. The setoff is being permitted, therefore, only to the extent that it encourages and facilitates the ultimate goal of rehabilitation. Accordingly, the setoff provision of the plan and the subsequent modification and approval of that provision by the Commonwealth Court shall also remain undisturbed.[10]

[10] The Commonwealth Court in modifying, then approving the setoff provision of the Plan also struck down several additional portions of the provision. First, Section III, F., limiting the maximum allowable setoff of $25,000,000 was excised from the Plan as having no explicit or implicit statutory authorization in rehabilitation or liquidation proceedings. Secondly, the Plan's provision in Section III, G., proclaiming Mutual Fire's books and records to be conclusive was also deleted due to the established inaccuracy of those books. We uphold these changes by the Commonwealth Court, pursuant to its statutory power to modify the Plan as caretaker of the Plan, and to correct potentially arbitrary and unjust provisions resulting in a more equitable procedure for all involved.

PRIORITY OF DISTRIBUTION[11]

Next, we examine the disposition rendered by the Commonwealth Court regarding the numerous challenges to the Plan's provision establishing the priority of distribution of claims to Mutual Fire's estate. Preliminarily, we dismiss the first challenge raised to, and addressed by, the Commonwealth Court concerning the Policyholders' objection to the Plan's June 30, 1991, cut-off date for recognition of loss claims. In order to foster the goals of rehabilitation, the Rehabilitator must be given the power to manage and control existing liabilities in order to reorganize and stabilize the financial structure of the insolvent insurer. We approve of the rationale engaged in by the Commonwealth Court when it opined:

> We find, however, no abuse of discretion in fixing this date. Given that Mutual Fire has not written business since mid-1986, a cut-off date set five years out from the cessation of business cannot be considered arbitrary or unreasonable. Moreover, the Rehabilitator has it within her authority to seek modification of that date if she deems it inappropriate. A determination can be better made by examining loss development experience as the 1991 date approaches. Therefore, we approve the June 30, 1991 date for the submission of loss claims as contained in Section II.H and VI.G of the Plan. This Court may, however, in the future direct the Rehabilitator to submit a recommendation as to whether the date should be extended.

[11] The Plan establishes separate classes of claims for the purpose of the priority of distribution. They are as follows:

> Class 1—Secured claims; Class 2—Administrative claims of the Estate and Guarantee Associations; Class 3—Wage claims; Class 4—Policyholder claims; Class 5—Surety Bond Lender claims; Class 6—General Unsecured claims, including claims of cedents and reinsurers; Class 7—Government claims; Class 8—Late claims; Class 9—Holders of Surplus and Contribution Notes; Class 10—Owners, Officers and Directors.

Grode v. Mutual fire, Marine and Inland Insurance Company, 132 Pa. Commw. Ct. 196, 212, 572 A.2d 798, 806 (1990). While the consequence of this date designating a specific date beyond which the filing of loss claims is barred might work some hardships, the procedure is not inflexible and is both reasonable and necessary to manage effectively the rehabilitation of Mutual Fire for the ultimate benefit of all claimants to the estate.

The next challenge raised before and addressed by the Commonwealth Court concerns the objections of six of the ninety-one banks and financial institutions who, as surety bond lenders, aliege they were improperly designated as a separate Class 5 in priority arguing that they were entitled to payment as Class 4 "policyholders." These objectors to the Plan (hereinafter "Lender Group") maintain that surety bonds are insurance policies entitling them to priority treatment under the Plan as Class 4 Policyholders. They assert that because the issuance of surety bonds is regulated by the Insurance Department, the participants in Mutual Fire's bond program are entitled to the same priority of distribution under the Plan as Class 4 policyholders.

Initially, the Commonwealth Court recognized that there exist fundamental differences between bilateral contracts of insurance and tripartite surety bond agreements. It concluded that the differences between their respective premium calculations, payments, and terms and conditions of cancellation and renewal, support "the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance." *Id.* at 213, 572 A.2d at 806.

The Commonwealth Court also rejected the previously made assertion that the fact that surety bond issuances are regulated by the Insurance Department is dispositive. Rather, the court adopted the view taken by the United States Supreme Court in *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 140 n. 19 (1962), wherein it stated: "Among the problems which would be raised by a contrary result would be the unsettling of the usual view, grounded in commercial practice, that suretyship is not insurance." *See* Cushman, *Surety Bonds on Public and Private Construction Projects*, 46 A.B.A. J. 649, 652-653 (1960). The Commonwealth Court correctly conclude:

> Moreover, accepting for the moment that surety bond coverage might be regarded as insurance because it is regulated by the Commonwealth insurance laws, we find no abuse of discretion in subordinating the claims of the lenders, who have recourse against investors through their own collection efforts, to those of policyholders, who will recover only what they can from Mutual Fire's estate and guarantee funds.

Grode, at 214, 572 A.2d at 806. We find no error in the rationale and determinations employed by the Commonwealth Court regarding this issue. Thus, the Commonwealth Court's approval of the Plan's creation of a separate Class 5 subordinating the surety bond lenders claims to those of the Class 4 policyholders was appropriate.

The Plan's established priority of distribution has been further assailed by the Lender Group which objects to the creation of a Class 6 fund. Specifically, Section II, F.6.1 provides the following:

> 1. Creation of Class 6 fund. On or before the Effective date, a segregated account (the "Class 6 Fund") shall be established by the Rehabilitator. The Class 6 Fund shall be funded by depositing in the Class 6 Fund, from time to time, twenty-five percent (25%) of all reinsurance collected by Mutual Fire, with respect to the assumed reinsurance business of Mutual Fire. All interest earned shall be transferred to the general account of the Rehabilitator and used by the Rehabilitator as a general unliened asset of the estate of Mutual Fire.

Plan at 17.

As the court properly noted in explaining why no abuse of discretion existed on the part of the Rehabilitator in creating separate Classes 5 and 6:

> [T]hese Class 5 lenders, who fall immediately behind the Class 4 policyholder but before Class 6 creditors, stand to benefit by what we perceive is an equitable innovation in the plan. Since under the Act the lenders are entitled to no higher distribution priority than general unsecured creditors, we find that the creation of Class 5 and the creation of a Class 6 segregated account are acts well within the Rehabilitator's discretion which do not violate the dictates of *Neblett*.

Id. at 214, 572 A.2d at 807.

The objectors to this provision maintain that as Class 5 lenders, the creation of the fund inequitably demotes them to a sub-class of creditors subordinate to the Class 6 of general unsecured creditors. Because the Insurance Act prohibits the Lenders Group from attaining a higher distribution priority than general unsecured creditors, the Commonwealth Court held that the establishment of a Class 5 and the funding of a

separate Class 6 account were provisions well within the Rehabilitator's broad discretion. Accordingly, the Court stated:

> In sum, we find the creation of both Class 5 and Class 6 to be a proper exercise of the Rehabilitator's discretion. If, after all, insurance is to perform its function of risk assumption and distribution of loss, then those statutes which govern it must first protect the insuring public, particularly in situations where the insurer becomes incapable of covering the risks it contracted to assume. Rehabilitation and liquidation are of vital importance to the consumer, who relies in the first place on the industry itself and then on its regulators for protection. No one can dispute that the consumer is not possessed of equal bargaining power, knowledge, or resources as that of the reinsurance entities and financial institutions which comprise the other major creditor classes in this proceeding.

Grode at 215, 572 A.2d at 807.

While perfection may be an unattainable characteristic of the Plan, this does not provide us with legitimate grounds for disturbing the more expert approval of provisions which are manifestly reasonable. So long as the provisions of the Plan strike a fair and proper balance between the competing secured and unsecured creditors the Plan must survive the objections raised to it.

UNITED STATES CLAIMS

The United States government also raises an objection to the Plan, complaining of the Class 7 status to which their claims were assigned. They object, citing 31 U.S.C. §3713 (1983), known as the Federal Priority Act which in relevant part requires that:

> (a)(1) A claim of the United States *shall be paid first when*—
>
> A) a person indebted to the government *is insolvent*. . .

31 U.S.C. §3713 (a)(1)(A) (emphasis added).

The Rehabilitator responds to this objection by arguing that the McCarran-Ferguson Act prohibits any federal statute from impairing or invalidating any state insurance regulation. 15 U.S.C. §1012. The Act states in pertinent part: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance . . . ." 15 U.S.C. §1012(b). We refrain from deciding the question concerning the applicability of the McCarran-Ferguson Act as did the Commonwealth Court. Suffice it to say, however, that we quote with approval both the factual determination made below and the resulting remedy temporarily ordered by the Commonwealth Court:

> Upon consideration of this objection and the Rehabilitator and other policyholders' responses thereto, we direct the Rehabilitator to set aside an amount which she finds in her discretion to be appropriate to pay United States Government claims. We further direct her to report to this Court the amount contained in this set-aside fund and will order the Plan to be so modified. We do this with the following considerations in mind.
>
> First, the Rehabilitator avers or contends that the only federal claims Mutual Fire has identified are (1) Federal Savings and Loan Insurance Corporation (FSLIC) receivership claims; (2) Environmental Protection Agency claims, "contingent and undetermined" according to the proofs of claims filed, against *insureds* of Mutual Fire; and (3) claims made by Westinghouse Electric

> Corporation against whom the United States may have claims. The United States does not dispute this averment that only these subrogated and third-party claims have arisen so far. We do not agree that the existence of these claims renders Mutual Fire a "person indebted to the Government," within the meaning of the Federal Priority Act. That is not to say, however, a debt due the United States could not arise, or that no federal claim *will* be filed.

Grode, at 216, 572 A.2d 798, 808 (emphasis in original).[12]

JUDGMENT CREDITORS

Pepsi-Cola Bottling Company of Charlotte, North Carolina, Inc. (hereinafter "Pepsi"), appeals from the Commonwealth Court's approval of the plan, alleging that as a federal court judgment holder against Mutual

[12] We are aware of decisions from other jurisdictions which do not recognize the McCarran-Ferguson Act as barring the federal government from obtaining first priority status in insolvency proceedings. *Matter of Union Indemnity Ins. Co. of New York*, 551 N.Y.S.2d 446, 146 Misc. 2d 558 (1990) (IRS unaffected by McCarran-Ferguson Act's regulation or insurance business). Instantly, the primary federal presence regarding claims against Mutual Fire concerns claims made by the Federal Deposit Insurance Corporation ("FDIC") and the Federal Savings and Loan Insurance Corporation ("FSLIC"). However, as the FDIC has been held not to be an integral part of the government scheme, FDIC claims have not been held to be a "claim of the United States Government," 31 U.S.C. §3713, which would therefore be entitled to priority. *Lapadula V. Villani, Inc. v. United States*, 563 F. Supp. 782 (S.D.N.Y. 1983). The FSLIC, has been held, in terms of its function, as identical to FDIC. *See In Re Federal Savings and Loan Insurance Corporation*, 837 F.2d 432, 434 (11th Cir. 1988); *Federal Savings and Loan Insurance Corporation v. Quinn*, 419 F.2d 1014, 1017 (7th Cir. 1969); *Federal Savings and Loan Insurance Corporation v. Williams*, 599 F. Supp. 1184, 1204 (D. Md. 1984). As the regulation of insurance companies both solvent and insolvent has been conceded to the states and since the goal of 15 U.S.C. §1012 was to exempt insurance activities from federal antitrust laws to preserve the state regulation of insurance companies, it would appear that the McCarran-Ferguson Act operates to preclude the applicability of the Federal Priority Act.

Fire, the principle of the Full Faith and Credit Clause of the United States Constitution mandates that it be given full payment, including interest, due to an alleged superiority of its claim, irrespective of the insurance rehabilitation proceedings.

Initially, the contention by Pepsi that it is entitled to an elevated priority by virtue of its status as a federal court judgment holder is both unsubstantiated and without merit. This theory is unsupported by existing case law and neither the provisions of 40 P.S. §221.14 *et seq.* providing for rehabilitation, nor 40 P.S. §221.19 *et seq.* providing for liquidation, contemplate a specific elevated priority for judgment creditors. As the Commonwealth Court stated in refuting this contention: "On the contrary, the serving of a judgment does not elevate the status of such claims." *Grode* at 217, 572 A.2d 798, 808 (*citing Davis v. Commonwealth Trust Co.*, 335 Pa. 387, 7 A.2d 3 (1939)).

While Pepsi may not be expressly entitled to an elevated priority for purposes of Class 4 distribution, another facet of the Plan's treatment of Pepsi warrants our discussion. Pepsi alleges that its judgment, including interest, against Mutual Fire was filed on September 4, 1986, one week before the Insurance Commissioner suspended the business of Mutual Fire and three months before the Commissioner filed the Petition for Rehabilitation. In approving the Plan, however, the Commonwealth Court recognized that the judgment in favor of Pepsi against Mutual Fire "is binding on and cannot be altered by the Rehabilitator." *Grode* at 217, 572 A.2d 798, 808. The problem concerns Section XVII of the Plan which expressly prohibits the payment of interest to creditors unless provided for in the Plan.

Thus, an apparent inconsistency exists which resulted in Pepsi filing a Motion For Clarification of the Commonwealth Court's Order approving the Plan, a motion which appears to remain without a ruling.

The case relied upon by both parties, *Davis v. Commonwealth Trust Co.*, 335 Pa. 387, 7 A.2d 3 (1939), while proper authority to deny Pepsi's earlier claim of elevated priority, is not analogous for purposes of the instant dilemma concerning the viability of interest awarded. In *Davis*, the issue concerned the claim of a creditor which had been awarded a judgment against the liquidating trustee by a court *years after the liquidation started.* Pepsi's judgment entered September 4, 1986 provides:

> NOW, THEREFORE, IT IS ORDERED, ADJUDGED AND DECREED that on its first claim for relief, denominated First Count in the complaint, plaintiff Pepsi-Cola Bottling Company of Charlotte, Inc. have and recover of and from defendant The Mutual Fire, Marine and Inland Insurance Company the principal sum of One Million Two Hundred Thousand Dollars ($1,200,000.00), plus interest thereon at the legal rate, eight percent (8%) per annnum, from and after the date of the breach, May 21, 1986, plus costs.

The Court noted that this judgment is binding, inviolate and not subject to any alteration by the Rehabilitator. We view that statement as an implied modification of the Plan's interest prohibition contained in Section XVII as respects Pepsi-Cola Company of Charlotte, Inc. While the Rehabilitator's equitable powers do afford her the authority to limit or deny interest which accrues *after a petition for rehabilitation or liquidation has* been filed, the federal judgment held by Pepsi including the amounts for interest expressly

provided for from May 21, 1986 must be accepted and given dignity up until December 4, 1986, the date the Insurance Commissioner sought to invoke her equitable powers pursuant to her Petition for Rehabilitation.[13]

Accordingly, we remand this issue to the Commonwealth Court for the purpose of modifying its January 23, 1990 Order, in favor of maintaining Pepsi-Cola Bottling Company of Charlotte, Inc. as a Class 4 policyholder creditor, for the full amount of the federal judgment entered on September 4, 1986, including all interest provided for between May 21, 1986 and December 4, 1986.

LOSS ADJUSTMENT EXPENSES

Numerous claimants have objected to the Plan complaining about the provision contained therein which provides for equal sharing of loss adjustment expenses by Mutual Fire and its policyholders as of April 1, 1989. These expenses are extensive, resulting from the necessity to retain a competent staff to manage and oversee the rehabilitation, a staff of claim adjusters, claim investigators and legal counsel. While many

[13] This result, we believe, properly satisfies the results of applicable case law. Under the Full Faith and Credit Clause, Article Four, Section One of the United States Constitution, and an implementing statute, 28 U.S.C. Section 1738, Pepsi's federal court judgment is to be accepted by the states as conclusive proof of the rights adjudicated. *See Stroll v. Gottlieb*, 305 U.S. 165, *reh'g denied*, 305 U.S. 675 (1938). The result of disallowing the payment of interest on Pepsi's judgment for any period beyond the date the Petition of Rehabilitation was filed, is also consistent with those decisions wherein courts have held that interest accruing on claims after insolvency proceedings have begun is payable only after the principal on all claims have been paid in full. *American Iron and Steel Manufacturing Co. v. Seaboard Airline Railway*, 233 U.S. 261, 266 (1914); *Commw. ex rel. Woodside v. Seaboard Mutual Casualty Co.*, 420 Pa. 237, 215 A.2d 673 (1966).

retainer arrangements were well intended, they were entered into prior to the insolvency. Now, presented with a dire need to economize in order to survive, the Rehabilitator must lead the process, free to eliminate or reduce many of the self-serving interests involved. While the effect of the Plan may cause economic suffering to some private contracting parties, we remain mindful that when an insurance company becomes insolvent, individual interests might have to be sacrificed or compromised in order to preserve the ultimate goal of this process, the overall good of the general public and the insurer's policyholders. *Vickodil v. Commonwealth Insurance Department*, 126 Pa. Commw. Ct. 390, 396-97, 559 A.2d 1010, 1013 (1989).

Accordingly, we find no error on behalf of the Commonwealth Court's modifying and approving the following portions of the loss adjustment expenses provision of the Plan. First, it is unquestionably reasonable to make modifications to the Plan which instill in it greater flexibility, mitigate some of the harsher consequences and emphasize a process of scrutiny which will guarantee a regular review of costs and expenses and a general system of accountability to the Court. We, therefore, adopt with approval the following language employed by the Commonwealth Court:

> Notwithstanding these changed conditions, in order to minimize the possibility of prejudice to the policyholders whose claims Mutual Fire is obligated to defend, we will modify Section IX of the Plan and direct that loss adjustment expenses be shared equally as provided in the Plan, but not until ninety days from the date of the Order entered today. We extend the date for the reduction of full payment of loss adjustment expenses in order to minimize any adverse consequences on the defense of claims.

> At the same time, we will further Order the Rehabilitator to review *all* employment and retainer agreements, including those of outside counsel and consultants employed with the Court's approval, with the aim toward renegotiation, where appropriate, and reduction of fees and expenses. It is obvious, though worth repeating, that each dollar expended in administrative and unreinsured loss adjustment costs and fees is a dollar taken away from the payment of claims. We therefore view this as a task of vital importance to the insureds and claimants and require that it be undertaken forthwith.

Grode at 218-19, 572 A.2d 798, 809 (emphasis in original).

PROPORTIONAL PAYMENTS METHOD

Section VI of the Plan allows for interim partial payments made periodically on Class 4 Adjusted Claims (Policyholder Loss Claims and Guaranty Association Loss Claims) of $5,000.00 or less per Adjusted Claim as cash is available. After a thorough review of this provision, the Commonwealth Court approved the Plan with the following modifications: first, payments were required to be made pursuant to this provision by June 1, 1990 according to a payment schedule and schedule of distribution dates submitted for the Court's approval; second, the Court modified the Plan "so that payments of these small claims to single persons or entities with more than one claim shall be taken into account in the proportional payment program." *Grode* at 219, 572 A.2d at 809. The Commonwealth Court agreed with the Policyholders Committee that "this latter modification will minimize the preference otherwise given to policyholders with multiple claims." *Id.*

The small payment provision will accelerate the disposition of numerous claims which would otherwise develop into greater expense to the estate. The payment of small claims whether adjusted or not by the date of the order approving the plan is likewise, legitimate and reasonable. As the Commonwealth Court properly reasoned, a distinction between adjusted claims or unadjusted claims which limited payment under this provision solely to unadjusted claims, "would punish these claimants who have thus far cooperated with the estate by resolving disputes and settling claims during the pendency of these proceedings." *Id.*

MISCELLANEOUS PROVISIONS

With regard to the Commonwealth Court's disposition of the jurisdictional issue, 40 P.S. §221.4, we are in complete agreement. Article V of the Insurance Act simply and plainly recognizes the Commonwealth Court's exclusive jurisdiction over delinquency proceedings. 40 P.S. §221.4(d) ("All actions . . . shall be brought in the Commonwealth Court in the Commonwealth of Pennsylvania"). Accordingly, it was appropriate for the Court to strike Sections VIII (c) and (e) as being inconsistent with the provisions of that Article. Conversely, it was also proper for the Court to approve Sections (a), (b), (d), (f) and (g) as they were viewed to correctly invoke the exclusive jurisdiction of the Commonwealth Court over matters concerning the interpretation of the Plan and the rehabilitation itself pursuant to 40 P.S. §221.4. Additionally, Section X.A, concerning dispute resolution of claims other than those subject to arbitration, was likewise approved below. The court's interpretation that the provision permits parties to a dispute to *request* the Commonwealth Court's intervention and resolution in lieu of arbitration is correct. We find no grounds for our intervention here.

DISSOLUTION OF THE POLICYHOLDERS COMMITTEE

Next, a large controversy surrounds the Plan's proposal to dissolve the Policyholders Committee appointed January 28, 1987 by the Court. The Commonwealth Court dissolved the Committee by Order of November 22, 1989.

The Policyholder Committee complains that not only is the Policyholder Class entitled to continued representation but that continued separate representation of the Class is necessary for adequate representation of the interests of Mutual Fire policyholders. Thus, they allege that the Commonwealth Court erred in dissolving the Committee. The Rehabilitator responds claiming that the real issue is not whether the Commonwealth Court acted improperly but whether she abused her discretion by determining that the Committee's fees and expenses should no longer be paid out of the estate of Mutual Fire after November 22, 1989. The Commonwealth Court, after thorough review of the competing positions, rejected the objection to the dissolution and concluded that those considerations of fairness which compelled the creation of the Policyholder Committee no longer existed in view of the outrageous cost its continued presence would have on Mutual Fire's diminished estate. We agree.

The Commonwealth Court concluded, that by virtue of the instant plan and especially due to the "hardship" and "proportional payment" provisions contained therein, those parties in particular need of protection, i.e., the small policyholders, now have their interests represented and protected. *Grode*, 132 Pa. Commw. at 222, 572 A.2d at 811. This unquestionably satisfies the

statutorily charged duty of the Rehabilitator to protect the interests of Mutual Fire insureds. Likewise, we adopt the rationale of the Commonwealth Court in approving its rejection of the Committee's claims that dissolution leaves the policyholders unrepresented. As President Judge Crumlish reasoned:

> As we have stated, the Rehabilitator is statutorily charged with that duty. Moreover, dissolution of the Policyholders Committee means only that this Court will not authorize payments of its costs and fees from Mutual Fire's estate. The Policyholders Committee may, as it sees fit, continue its activities outside the Court's aegis, as have the other creditors' groups known as the "lender group" and "cedents' group." Of course, individual policyholders also continue to have an opportunity to be heard.

Id.[14]

We next consider the Commonwealth Court's elimination of Section XIII B, the immunity provision contained in the Plan, on the basis that it was unjustified and supererogatory since no such provision in the Plan "may confer upon the Rehabilitator, her deputies or agents immunity greater than that given by Pennsylvania law as codified in Sections 8501-8528 and 8541-8564 of the Judicial Code, 42 Pa. C.S. §§8501-8528, 8541-8564." *Grode* at 222-23, 572 A.2d at 811. Sections

[14] The Plan, once approved should be structured to equitably address all eventualities, conflicts and concerns. As we view the Plan to most efficiently and equitably do so, the role of the Policyholder Committee as representative of policyholder interests is no longer necessary. Indeed, in view of the testimony offered regarding the Committee's numerous attempts to interfere with the Plan, ignore Orders of the Court and bill the estate of Mutual Fire millions of dollars in expenses and fees, its continued presence may be an unacceptable financial detriment.

8521 *et seq.* of the Judicial Code, 42 Pa. C.S. §8501-8528 dealing with Sovereign Immunity, expressly enumerate the limited exceptions to the general prohibition against holding a Commonwealth Agency and any of its employees liable with respect to acts within the scope of their office or agency. The Rehabilitator and her deputies as agents of the Commonwealth are controlled by these provisions and its limitations. Accordingly, the Commonwealth Court reasonably eliminated the immunity provision as unnecessary and inconsistent with the controlling, applicable statutes regarding Sovereign Immunity.

Finally, we address the Plan's indemnification agreement and the Commonwealth Court's approval of this provision. First, the Policyholders Committee argues that certain employment agreements entered into by the Rehabilitator ought to be disapproved. Specifically, they seek to eliminate the employment of more than one deputy and strike those portions of the agreements with the appointed deputies and other employees which contain indemnification agreements. We agree with the Commonwealth Court, who in rejecting this contention stated that pursuant to 40 P.S. §221.16(a) and (b) the Rehabilitator is given

> express power to "appoint a special deputy who shall have all the powers of the Rehabilitator" and who shall "serve at the pleasure of the Commissioner." In addition, the Rehabilitator "shall have full power to direct and manage, to hire and discharge employes . . . ." We do not find it unreasonable or arbitrary that the Rehabilitator has chosen to appoint a deputy and an "assistant special deputy" to implement a rehabilitation and to manage an estate of this magnitude.

Grode at 223, 572 A.2d at 811. We find no fault with this rationale or conclusion.

The Policyholders Committee also argues that indemnification agreements between the Rehabilitator and her deputies are necessarily void as against public policy, relying upon *Dilks v. Flohr Chevrolet, Inc.*, 411 Pa. 425, 192 A.2d 682 (1963), and *In re Hodgson's Estate*, 342 Pa. 250, 20 A.2d 294 (1941). First, despite these objections, the Commonwealth Court upheld the indemnity provisions and their legitimacy, distinguishing the present matter from *Hodgson's Estate, supra*, in which the rule applied in the context of testamentary trust litigation. The court held that the rehabilitation deputies do not act in the same fashion as executors or administrators in a probate context. The court then rejected the Policyholders Committees' reliance upon *Dilks, supra*, which it held did not "stand for the proposition that exculpatory clauses, which may be voided as against policy, *Boyd v. Smith*, 372 Pa. 306, 94 A.2d 44 (1953), and *indemnity* provisions receive the same treatment under Pennsylvania law." *Grode* at 224, 572 A.2d at 812 (emphasis in original). Rather, the Commonwealth Court found persuasive and relied upon the reasoning of the United States Court of Appeals for the Third Circuit in *Jamison v. Ellwood Consolidated Water Co.*, 420 F.2d 787, 789 (3d Cir. 1970), to reach its conclusion that the public policy concerns regarding exculpatory clauses were not determinative of the legality of indemnity agreements. Furthermore, the court identified some valid policy concerns in support of its rejection of the Policyholders Committees' arguments and in upholding the appropriateness of the indemnity agreement, stating:

> In order to attract persons of proven ability, that necessity dictates that those persons be somehow insulated from the fears and costs of possible litigation by naturally disgruntled

> claimants and other creditors who will inevitably suffer some loss. To this end, the Rehabilitator has adopted a reasonable policy of indemnifying her deputies for all actions within the scope of their appointed duties.

Grode, at 223, 572 A.2d at 812.

While the Plan as modified and approved by the Commonwealth Court and as modified by this Opinion may adversely affect some individual interests, we believe that it legitimately seeks to equitably apportion unavoidable losses and is free from arbitrary or capricious provisions which would render the Plan unacceptable as an abuse of the Rehabilitator's discretion.

Accordingly, after a thorough review of the objections presented and the various components of the Plan, we remand Section XVII of the Plan to the Commonwealth Court to modify that provision consistent with this Opinion. We approve the remaining provisions of the Plan as modified by the Commonwealth Court. Affirmed in part, remanded in part.

Mr. Justice Larsen and Mr. Justice McDermott did not participate in the consideration or decision of this case.

DATED: August 21, 1992
JUDGMENT ENTERED:

/s/ MILLARD E. WILLIAMSON
Deputy Prothonotary

OPINION OF THE COMMONWEALTH COURT OF PENNSYLVANIA

(Filed January 23, 1990)

No. 3483 C.D. 1986

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,
Plaintiff,

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,
Defendant.

BEFORE: HONORABLE JAMES CRUMLISH, JR., *President Judge*

HEARD: July 25, 26, 28, and August 1, 1989

OPINION

OPINION BY
PRESIDENT JUDGE CRUMLISH, JR.

Constance Foster, Commonwealth Insurance Commissioner, as statutory Rehabilitator (Rehabilitator), has petitioned this Court for approval of her modified Plan of Rehabilitation (Plan) for the Mutual Fire, Marine and Inland Insurance Company (Mutual Fire), a mutual casualty insurance company created and chartered under the laws of Pennsylvania. Commissioner Foster seeks

this Court's approval pursuant to Section 516(d) of Article V of the Act of May 17, 1921, P.L. 789, *as amended*, added by the Act of December 14, 1977, P.L. 280, 40 P.S. §221.16(d) (known as The Insurance Company Law of 1921 (Act)). We modify the Plan in part and hereby approve it.

Before proceeding with disposition of the Plan and the various objections thereto, we briefly summarize the events leading to this decision.

Mutual Fire, founded in 1902, was primarily a property and casualty insurance carrier for most of its history. In the late 1970's, Mutual Fire, along with others in the industry, became more heavily entrenched in reinsurance arrangements with other carriers. Generally speaking, under these arrangements, Mutual Fire ceded a portion of its business to other insurers who agreed to protect Mutual Fire from the risks it undertook. Conversely, Mutual Fire assumed business from other insurers under the same or similar agreements. By the mid-1980's, between 60% and 70% of Mutual Fire's business entailed reinsurance, involving over 8,000 agreements or "treaties" worldwide. At approximately that time, Mutual Fire also wrote a large number of surety bonds as part of financing packages for oil, gas and real estate limited partnerships. In addition, Mutual Fire's "direct book" liability coverage began to show diminishing profitability.

We need not dwell too long, however, on the causes of Mutual Fire's financial straits for purposes of this determination. Suffice it to say that at year-end 1988, immediately before the present Plan was proposed, Mutual Fire's deficit was over $400 million, constituting the country's fourth largest insurer insolvency.[1]

[1] McLeod, "New Mutual Fire Rehabilitation Plan Proposed." *Business Insurance*, March 6, 1989, at 3.

THE 1987 PLAN OF REHABILITATION

In December 1986, George F. Grode, then Commonwealth Insurance Commissioner, sought, with the consent of Mutual Fire's officers and directors, appointment as Rehabilitator of Mutual Fire, Section 515(a) of the Act, 40 P.S. §221.15(a), and submitted a rehabilitation plan. Prior to his petition, Commissioner Grode had placed Mutual Fire under his supervision. Section 510(d) of the Act, 40 P.S. §221.10(d).[2] At the time the petition was filed, Mutual Fire reported assets of $99.4 million and total liabilities of $260.1 million, with a negative policyholders surplus of nearly $161 million.[3]

When it became apparent to this Court that adequate notice had not been given to policyholders and other creditors on whom the original plan would have a direct and substantial impact, hearing on its approval was continued generally. At the same time, we directed the Insurance Department to prepare a notice of hearing to be sent to all known policyholders and creditors indicating the procedure for obtaining the plan and raising objections prior to a Court hearing on its approval. Thereafter, many objections were made. These objections were drawn from individual policyholders, claimants against policyholders, reinsurers doing business with Mutual Fire, creditors and agents of Mutual Fire.

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[2] The supervision order was entered September 13, 1986. Such orders enjoin the insurer from disposing, conveying or encumbering assets; withdrawing bank accoutns; lending or investing funds; transferring properties; incurring debts or other obligations or entering any new reinsurance contracts without prior approval. 40 P.S. §221.10(d).

[3] Annual Statement 1986, Exhibit No. 7, 7/26/89.

In early 1987, upon application of several policyholders, also objectors to the plan, this Court formed a Committee of Policyholders (Policyholders Committee), whose purpose was to "consult with the statutory rehabilitator on the administration of this matter and advise those represented as to the proposed plan."[4] This Court formed the Policyholders Committee with the express intent of assuring that policyholders *first and foremost* suffered the least amount of harm resulting from the unfortunate series of events culminating in this insurance company's reorganization effort.[5]

The Rehabilitator, now Commissioner Foster, thereafter filed her responses to the objections to the proposed rehabilitation plan. The Policyholders Committee and numerous other parties strenuously objected to this proposed plan on the grounds, *inter alia*, that the Rehabilitator had released no financial information or documentation to substantiate the projections of 100% payment to policyholders contained therein. Hence, this Court ordered the Rehabilitator to allow the Policyholders Committee and all interested persons access to Mutual Fire's books and records. A hearing date was then set for June 3, 1987.

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[4] Order of January 28, 1987.

[5] The liquidation provisions of Article V elevate the "claims under policies for losses wherever incurred, including third party claims, against the insurer for liability for bodily injury or for injury to or destruction of tangible property which are not under policies . . . ," Section 544(c) of the Act, 40 P.S. §221.44(c), to the highest priority of distribution after wage claims, 40 P.S. §221.44(a), and administrative expenses, 40 P.S. §221.44(b). Although there is no Pennsylvania authority directly on point, we agree with decisions in other jurisdictions construing similar insurance insolvency statutes that the equitable purpose of rehabilitation and liquidation is to protect *first of all* consumers of insurance. *See, e.g., State ex rel. Long v. Beacon Insurance Co.*, 87 N.C. App. 72, 359 S.E.2d 508 (1987).

At that hearing, various stipulations by and among the objecting parties (including the Policyholders Committee) were entered. The proposed plan was approved, subject to those stipulations, which altered it materially but in a manner not pertinent to this discussion.

Several months later, the Rehabilitator, pursuant to this Court's Order approving the proposed plan, filed a report on the progress of the rehabilitation for the period December 8, 1986 (the date on which the statutory Rehabilitator was appointed) to October 26, 1987. At the same time, the Rehabilitator sought additional time to evaluate the feasibility of its implementation. We granted the Rehabilitator's request for additional time and directed her to submit to the Court a schedule of tasks to be performed in order to complete the evaluation.[6] Among these tasks were the engagement of litigation counsel to investigate possible causes of action by the Rehabilitator on behalf of Mutual Fire, Section 516(c) of the Act, 40 P.S. §221.16(c); the appointment of a professional firm to perform actuarial analyses of Mutual Fire's loss reserves; and the engagement of auditing and clams settlement services, Section 516(b) of the Act, 40 P.S. §221.16(b). At that time, the Rehabilitator opposed the Policyholders Committee's motion to appoint an independent manage to oversee the rehabilitation on site.

On May 2, 1988, the Rehabilitator filed her report on the feasability of implementing the amended plan approved June 26, 1987. After close consultation, pursuant to Section 515(c) of the Act, 40 P.S. §221.15(c), this Court and Commissioner Foster determined that any viable rehabilitation of this magnitude would necessarily

[6] Order of October 27, 1987.

demand sufficient legal, managerial, financial and technical resources. It was therefore decided that initially a deputy rehabilitator would be appointed, Section 516(a) of the Act, 40 P.S. §221.16(a), and legal counsel would be retained to investigate possible sources of recovery through litigation where litigation was deemed fruitful to collect the recoverables comprising a significant portion of this estate's assets.[7]

On June 1, 1988, having reviewed the Rehabilitator's report on plan implementation, which indicated the 1987 plan was not feasible for several reasons, we directed the Rehabilitator to submit a modified plan.[8] The plan was to include a provision to trigger applicable state insurance guarantee funds (both in Pennsylvania and other states) and a provision for proportionate periodic payments of policyholder claims. Additional counsel was hired to assist the Rehabilitator in formulating a modified plan.

Thereafter, the Rehabilitator applied to this Court for approval to suspend payment of certain loss adjustment expenses incurred under Mutual Fire's

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[7] Since that time, the Rehabilitator has by writ of summons or complaint instituted legal action against, *inter alia*, Peat, Marwick, Main & Co., seeking damages of in excess of $350 million; GET Reinsurance Limited, seeking damages in excess of $13 million; the Berwind Corporation for 18 U.S.C. §1962 ("RICO") violations, fraud and other causes of action. The Rehabilitator has also brought suit against Chesapeake Insurance Company, Ltd.; and Keswick & Curran, Incorporated. Additional litigation will be commenced when it is determined to be in the best interest of the estate.

[8] Order of June 1, 1988. In her feasibility report, the Commissioner indicated, *inter alia*, that reserves on a portion of Mutual Fire's direct book were substantially in excess of estimates assumed in the 1987 plan; that collection of reinsurance recoverables would require resort to protracted litigation; and that an assumed favorable resolution of Mutual Fire—"Resolute Re" arbitration had not at that time occurred.

obligations to defend its insureds. The Rehabilitator also asked this Court for a determination that Mutual Fire was insolvent.[9]

The Rehabilitator submitted a new Plan of Rehabilitation January 31, 1989. After notice was issued to policyholders and all known creditors and was published in periodicals of general and industry circulation, numerous objections were filed. This Court, over the course of four days, heard testimony and argument in support of and against certain provisions of the Plan. It is this Plan and the objections filed thereto which we now address.

REHABILITATION v. LIQUIDATION

Objections to the Plan were raised on the grounds that it is, in name only, a rehabilitaiton and is in effect a liquidation. The objectors argue, therefore, that the Rehabilitator should be ordered to liquidate Mutual Fire. Several objectors maintain that it is anomalous to rehabilitate an insurance company that has been determined insolvent. We are not persuaded by their arguments, however.

Initially, we recognize that insolvency is one of several expressly enumerated grounds on which an order of rehabilitation may be based. Section 514(1) of the Act, 40 P.S. §221.14(1). Thus, the statute admits of circumstances in which insolvent insurers are to be rehabilitated. *See, e.g., Insurance Department v.*

[9] On February 3, 1989, this Court, after examining Mutual Fire's records, determined it to be insolvent as that term is defined in Section 503 of the Act, 40 P.S. §221.3. We expressly declined to make a finding as to when Mutual Fire became insolvent. This determination of insolvency triggered guaranty fund association coverage.

Safeguard Mutual Insurance Co., 18 Pa. Commonwealth Ct. 195, 336 A.2d 675 (1975), *aff'd as modified*, 478 Pa. 592, 387 A.2d 647 (1978).

The statute authorizes the *Commissioner to petition the Commonwealth Court* for liquidation, Section 517 of the Act, 40 P.S. §221.17, and an order to liquidate requires notice and hearing. Section 520 of the Act, 40 P.S. §221.20. The Rehabilitator has not put forth such a petition.

Moreover, we agree with the Rehabilitator and, at least one objector to the Plan, that the benefits of rehabilitation—its flexibility and avoidance of inherent delays—are preferable to the static and cumbersome procedures of statutory liquidation. The statute's purpose is, in the end, that to which we must give effect. That legislatively stated purpose is "the protection of the interests of insureds, creditors, and the public generally . . . ." and the "equitable apportionment of any unavoidable loss" through, *inter alia*, "improved methods for rehabilitating insurers. . . ." Section 501 of the Act, 40 P.S. §221.1. No interest is served by adding to the delay which has already occurred in this case. On the contrary, the goals of Article V of the Act are better served by a rehabilitation which effectively ensures more distribution in a shorter period of time than would occur in liquidation. *See Neblett v. Carpenter*, 305 U.S. 297 (1938).[10]

[10] Objectors rely in *Neblett* for the proposition that the Rehabilitator cannot fashion a Plan which does not give a party in rehabilitation the same or greater *rights* than he would have in liquidation. The effect of this principle on the Rehabilitator's proposed Plan will be discussed later in this opinion.

Notwithstanding those objectors' protestations that this is a *de facto* liquidation, we find nothing in the statute precluding the Rehabilitator from pursuing this rehabilitation as an improved method for rehabilitating insurers, particularly where the record indicates that affected persons, including the objecting creditors, would, *at least in terms of amounts* recovered, fare better under this rehabilitation than in statutory liquidation. Rehabilitator's Exhibits Nos. 5 and 6, 7/25/89.

The Plan itself calls for Mutual Fire's possible corporate restructure, and Mutual Fire will maintain its required capital and surplus minimums. The record also indicates that rehabilitation will preserve the value of Mutual Fire's insurance charters and perhaps the even greater value of operating losses. Notes of Testimony (N.T.), 7/25/89, pp. 88-90. This Court is aware of at least two instances where potential buyers have approached the Rehabilitator's deputy. N.T., 7/25/89, pp. 151-152. Of course, no one disputes that the rehabilitation as proposed contemplates the windup of Mutual Fire's current business, but it is not altogether accurate to say that the Rehabilitator intends no rehabilitative purpose. It must be remembered that Mutual Fire's assets, liabilities and operations were of a far smaller order of magnitude prior to the expansion of the reinsurance and surety bond business in the late 1970's and early 1980's.

This Court has held that the Act itself evidences the General Assembly's intent to treat rehabilitations and liquidations as separate, distinct proceedings. *Muir v. Transportation Mutual Insurance Co.*, 105 Pa. Commonwealth Ct. 156, 523 A.2d 1190 (1987). The differences between the rehabilitation and liquidation provisions are readily apparent. The liquidation provision fixes the rights and liabilities of the insurer and its

creditors as of a date certain, Section 521 of the Act, 40 P.S. §221.21; the rehabilitation statute is silent on this matter. The liquidation provision establishes an order of distribution, Section 544 of the Act, 40 P.S. §221.44; the Act's rehabilitation section does not. Significantly, the liquidation provision expressly allows for setoffs, Section 532 of the Act, 40 P.S. §221.32; no such mention is made in that part of the statute governing rehabilitations.

The lack of express direction governing rehabilitations where it is otherwise given in liquidation proceedings compels the conclusion that the Insurance Commissioner, as Rehabilitator, is given broader discretion to structure a rehabilitation plan than is given to her as statutory liquidator. *Id.* In limiting this discretion, the General Assembly has given this Court, by virtue of the Judicial Code, 42 Pa. C.S. §761(a)(3), and Section 504(a) of the Act, 40 P.S. §221.4(a), the jurisdiction and authority to oversee rehabilitation proceedings in this Commonwealth, The Court may "approve . . . disapprove . . . or modify" a plan proposed to it. 40 P.S. §221.16(a). We are aware, however, of the well-settled principle that judicial discretion may not be substituted for administrative discretion. *Blumenschein v. Housing Authority of Pittsburgh*, 379 Pa. 566, 109 A.2d 331, *appeal dismissed*, 350 U.S. 806 (1954).

Thus, we perceive that the Rehabilitator's broad powers in these proceedings are circumscribed by this Court's mandate to act as a check on potential discretionary abuse and to insure equitable apportionment of loss. Of course, the Rehabilitator is constrained by constitutional mandate.

As has been noted, many objectors rely on *Neblett* to urge that the Rehabilitator has abused her discretion in fashioning a plan which affords to interested persons less

rights than those they would enjoy in liquidation. Without conceding that the proposed Plan has this effect, the Rehabilitator agrees that *Neblett* requires claimants be treated the same or better than in liquidation. We shall not belabor this point except to agree with the parties that the Plan must also be viewed in the light of this principle.

IMPAIRMENT OF CONTRACTUAL RIGHTS

Several objectors contend that the Plan unlawfully impairs their various contractual rights. This Court finds that these alleged impairments are, for the most part, insubstantial and do not warrant modification of the Plan except as hereinafter provided.

The Act and caselaw implicitly recognize that contractual terms are not sacrosanct when an insurance company is insolvent. *See Vickodil v. Insurance Department*, 126 Pa. Commonwealth Ct. 390, 559 A.2d 1010 (1989). As in public utilities, the insurance industry is subject to particularly strict regulation by state government because the impact of an insolvent insurer's contracts is not limited to the named parties. *See Energy Reserves Group, Inc. v. Kansas Power & Light Co.*, 459 U.S. 400 (1983). This is particularly applicable to the contracts for reinsurance without which Mutual Fire would have been unable to expand its business. Rather, those contracts entered into by Mutual Fire have affected thousands of members of the public. Of course, individual parties to those contracts cannot be expected to protect this public interest. Thus, the General Assembly, pursuant to its inherent police power to safeguard the public interest, has authorized the Commissioner to represent these interests in order to minimize the harm to all affected parties—insureds,

creditors and the public generally—from the potentially devastating consequences of insurance insolvency. 40 P.S. §221.1 If the Commissioner determines that rehabilitation, as opposed to liquidation, is the most efficient means of representing these interests, and this Court finds no abuse of her discretion, then contractual impairments that are insubstantial and reasonably necessary to implement a rehabilitation plan cannot be deemed unlawful. *Energy Reserves Group.* "[A]n impairment may be constitutional if it is reasonable and necessary to serve an important public purpose." *U.S. Trust Co. of New York v. New Jersey*, 431 U.S. 1, 25 (1977). We are convinced that Mutual Fire's rehabilitation serves an important public purpose. Hence, we examine the "extent of impairment[s]" to determine their reasonableness. *Id.* at 27.

Except for the Plan modifications outlined in this opinion, the Court finds that the alleged contractual impairments are insubstantial and reasonably designed to enable the Commissioner to satisfy *all* claims in an equitable and orderly manner.

SETOFF

The Plan as now proposed contains, in effect, three definitions of offset. The first provides that mutual debt and credits are only those Due and Owing[11] on December 31, 1986. The optional definition, which may be elected by reinsurers who are also cedents by paying the amount due and owing Mutual Fire within ninety days of plan approval, is the lesser of Mutual Fire's obligation to a cedent for Due and Owing, plus reported case reserves,

[11] The term "Due and Owing" is in turn defined as reinsurance recoverable on *paid* losses, *paid* loss adjustment expenses, claim settlement and reimbursement agreements. Section I.II of the Plan (emphasis added).

plus Incurred But Not Reported ("IBNR") losses as of March 31, 1986, *or* the cedent's obligation to Mutual Fire for balances due and owing, plus case reserves as of December 31, 1986. Lastly, insurers paying Due and Owing within ninety days of Plan approval will receive a 10% discount if they waive any and all rights to setoff.

We will examine the optional setoff definition contained in Section III.E.2, the definition most generous to Mutual Fire's creditors according to the record, Rehabilitator's Exhibit No. 4, 7/25/89, on the assumption that those creditors using the more restrictive definition have consented to do so.

We first note that Article V's rehabilitation section contains no definition of setoff while the liquidation provision does. We have already stated that this evidences an intent that rehabilitation proceedings are distinct from liquidation proceedings. *Muir.* If the Rehabilitator's formulation of a plan is not arbitrary or unreasonable, then that plan should be approved if it does not diminish the rights a creditor would have in liquidation.

The Plan's treatment of rights of setoff, found not only in specific contracts but also in common law, must be modified as follows.

Section III.E.2.a, pertaining to setoff by reinsurers who are also cedents, shall read so as to compute balances as of December 4, 1986, the date on which the Commissioner filed the petition for rehabilitation. Had the Commissioner petitioned for liquidation rather than rehabilitation on that date, these objectors' rights would be fixed as of that filing date. Section 520 (d) of the Act, 40 P.S. §221.20(d). Thus, this Plan modification assures

that those objectors receive substantially the same setoff rights and treatments they would receive in a liquidation.

Section III.F., placing a $25,000,000 cap on total allowable setoff is stricken. There is no provision for a maximum setoff allowance in liquidation proceedings and no legal justification for this restriction.

Further, the Plan's provisions, proclaiming Mutual Fire's books and records to be conclusive, are stricken. Due to the established inaccuracy of Mutual Fire's records, this condition substantially impairs the objectors' right to an accurate accounting. Therefore, the Plan is modified to provide that the figures in Mutual Fire's books may be contested through the Plan's claims and disputes resolution procedures.

PRIORITY OF DISTRIBUTION

A. *Cut-off Date for Submission of Class 4 Loss Claims*

The Policyholders Committee and (not surprisingly) individual policyholders whose businesses expose them to a "long tail" of liability, object to June 30, 1991, as the cut-off date for recognition of loss claims. The Plan as proposed provides that all such claims reported thereafter will be included in Class 8 ("late claims") priority.

We find, however, no abuse of discretion in fixing this date. Given that Mutual Fire has not written business since mid-1986, a cut-off date set five years out from the cessation of business cannot be considered arbitrary or unreasonable. Moreover, the Rehabilitator has it within her authority to seek modification of that date if she deems it inappropriate. A determination can be better made by examining loss development

experience as the 1991 date approaches. Therefore, we approve the June 30, 1991 date for the submission of loss claims as contained in Section II.H and VI.G of the Plan. This Court may, however, in the future direct the Rehabilitatior to submit a recommendation as to whether the date should be extended.

B. *Lenders as Policyholders*

Six of the ninety-one banks and financial institutions which participated in the Mutual Fire surety bond program have jointly objected to their placement in Class 5 of the Plan's distribution schedule. Known informally as "the Lender Group," these lenders have put forth their view that the surety bonds are insurance policies, entitling them to treatment under the Plan as Class 4 policyholder recipients.

This theory has engendered much controversy in these proceedings, and its proponents as well as opponents have referred us to a wealth of authority for their respective positions. Despite this, our research has revealed no Commonwealth precedent which holds squarely that a surety bond is (or is not) an insurance policy. Thus, we view this as an issue of first impression. For the reasons which follow, we conclude that participants in Mutual Fire's surety bond program are not entitled to the same treatment as Class 4 claimants.

First, we acknowledge the fundamental differences pointed out to this Court between bilateral contracts of insurance and tripartite surety bond agreements. Unlike insurance policies, surety bond premiums are not determined by the insurer on the basis of loss but rather on the *lender's* evaluation of risk. Premiums are paid *not by the lenders* but by the investors; they are paid "up-front" and are not subject to adjustment. The

instruments have no fixed terms and no right of cancellation or renewal. These factors support the conclusion that the surety bonds are in the nature of commercial guarantee instruments rather than policies of insurance.

Second, we do not find it dispositive that the issuance of these bonds is regulated by the Insurance Department. *Group Life & Health Insurance Co. v. Royal Drug Co.*, 440 U.S. 205 (1979); *see also* Backman, *Surety Rate-Making* (1948). If, as the lenders argue, the best evidence of the lenders' policyholder status is provided by the bond instrument itself, then there is ample argument in the instrument's title, "Financial Surety Bond for Limited Partnerships," to counter the notion that the use of the term "policy" in the documents render them insurance contracts. Regardless, we must look beyond these contradictory references and any other nomenclature contained therein to examine the essence of these transactions. We adopt, as has the United States Supreme Court, "the usual view, grounded in commercial practice, that suretyship is not insurance." *Pearlman v. Reliance Insurance Co.*, 371 U.S. 132, 140 n. 19 (1962); *see also American Insurance Association v. Clarke*, 656 F. Supp. 404 (D.C. 1987) (municipal bond "insurance" is a bank credit transaction functionally equivalent to a standby letter of credit).

Moreover, accepting for the moment that surety bond coverage might be regarded as insurance because it is regulated by the Commonwealth insurance laws, we find no abuse of discretion in subordinating the claims of the lenders, who have recourse against investors through their own collection efforts, to those of policyholders, who will recover only what they can from Mutual Fire's estate and guarantee funds.

We find that, even if these bonds were contracts of insurance, the legislature has excluded them from coverage under The Pennsylvania Insurance Guaranty Association Act, Act of November 25, 1970, P.S. 232, *as amended*, 40 P.S. §§1701.101—1701.605. This exclusion evidences an intent not to afford surety holders the protections given by this Act to consumers of insurance whose carrier becomes insolvent.

For these reasons, we conclude that participants in the surety bond lender program would not fall within the same claimant class as "direct book" policyholders were Mutual Fire in liquidation. Thus, their rights are not diminished by their placement in Class 5 of the Plan's distribution schedule. Accordingly, we approve Section II.E of the Plan.

C. *Creation of Class 6 and Class 6 Fund*

The Lender Group has objected to the creation of a segregated Class 6 fund to be funded by the deposit of 25% of all reinsurance Mutual Fire collects. No portion of this fund shall be paid unless and until this Court enters an Order authorizing initial distribution, and until Class 4 loss claims are paid in full.

The Lender Group, who stands to receive distributions in Class 5 before general creditors in Class 6, argues that this set-aside is inequitable and renders them a sub-class of creditors junior to general unsecured creditors (i.e., principally cedents), in violation of the Act's liquidation provisions.

However, these Class 5 lenders, who fall immediately behind the Class 4 policyholders but before Class 6 creditors, stand to benefit by what we perceive is an equitable innovation in the Plan. Since under the Act the

lenders are entitled to no higher distribution priority than general unsecured creditors, we find that the creation of Class 5 and the creation of a Class 6 segregated account are acts well within the Rehabilitator's discretion which do not violate the dictates of *Neblett*.

In sum, we find the creation of both Class 5 and Class 6 to be a proper exercise of the Rehabilitator's discretion. If, after all, insurance is to perform its function of risk assumption and distribution of loss, then those statutes which govern it must first protect the insuring public, particularly in situations where the insurer becomes incapable of covering the risks it contracted to assume. Rehabilitation and liquidation are of vital importance to the consumer, who relies in the first place on the industry itself and then on its regulators for protection. No one can dispute that that consumer is not possessed of equal bargaining power, knowledge, or resources as that of the reinsurance entities and financial institutions which comprise the other major creditor classes in this proceeding.

D. *United States Claims*

United States claims are treated under the Plan as Class 7 claims. The United States government objects to the Plan because it does not accord first priority of payment of debts due the United States. It is asserted that this treatment violates 31 U.S.C. §3713 (1983), known as the Federal Priority Act, which requires that a United States government claim "shall be paid first when . . . a person indebted to the Government is insolvent . . . ."

The Rehabilitator counters that the Federal Priority Act is inapplicable to these proceedings because the McCarran-Ferguson Insurance Regulation Act, 15 U.S.C. §1012 (1976),[12] precludes the impairment or invalidation of state insurance law by any federal statute.

Upon consideration of this objection and the Rehabilitator and other policyholders' responses thereto, we direct the Rehabilitator to set aside an amount which she finds in her discretion to be appropriate to pay United States government claims. We further direct her to report to this Court the amount contained in this set-aside fund and will order the Plan to be so modified. We do this with the following considerations in mind.

First, the Rehabilitator avers or contends that the only federal claims Mutual Fire has identified are (1) Federal Savings and Loan Insurance Corporation (FSLIC) receivership claims; (2) Environmental Protection Agency claims, "contingent and undetermined" according to the proofs of claims filed, against *insureds* of Mutual Fire; and (3) claims made by Westinghouse Electirc Corporation against whom the United States may have claims. The United States does not dispute this averment that only these subrogated and third-party claims have arisen so far. We do not agree that the existence of these claims renders Mutual Fire a "person indebted to the Government," within the meaning of the Federal Priority Act. That is not to say, however, a debt due the United States could not arise, or that no federal claim *will* be filed.

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[12] 15 U.S.C. §1012(b) provides, in pertinent part: "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . ."

Second, although we need not decide today whether the McCarran-Ferguson Act applies to preclude the application of the Federal Priority Act, we have already recognized that the Commonwealth's Insurance Company Law governing rehabilitations is, as was said in *SEC v. National Securities, Inc.*, 393 U.S. 453 (1969), "aimed at protecting or regulating this relationship [between insurer and insureds] directly or indirectly." *Id.* at 460. Thus, Article V would be deemed a law regulating the "business of insurance." *Id.*[13] If, after all, liquidation of insolvent insurance companies were *not* the business of insurance relegated to the states' governance by McCarran-Ferguson, the federal Bankrupty Code would obviate the need for this statute and similar acts in other states. Hence, McCarran-Ferguson would appear to preclude the application of the Federal Priority Act.

E. *Judgment Creditors*

Pepsi-Cola Bottling Company of Charlotte, Incorporated, (Pepsi-Cola), has objected to the Plan on the ground that as a federal court judgment holder against Mutual Fire, it is entitled to elevated priority when distributions are made to Class 4 policyholders. Although we agree that this judgment is binding on and cannot be altered by the Rehabilitator, Pepsi-Cola points to no authority—and we have found none—for the position that it is entitled to payment before other policyholders.

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[13] Notwithstanding the Ninth and Fourth Federal Circuit decisions to the contrary, we note the Third Circuit has stated that state-regulated insurance insolvencies are the business of insurance authorized by McCarran-Ferguson. *Lac D'Amiante Du Quebec, Ltee v. American Home Assurance Co.*, 864 F.2d 1033 (3d Cir. 1988), citing *United States Service Auto Association v. Muir*, 792 F.2d 356 (3d Cir. 1986), *cert. denied*, 479 U.S. 1031 (1987).

Neither the rehabilitation nor liquidation provisions of Article V sets forth any priority for judgment creditors. On the contrary, the serving of a judgment does not elevate the status of such claims. *Davis v. Commonwealth Trust Co.*, 335 Pa. 387, 7 A.2d 3 (1939).

Accordingly, we approve Section II of the Plan as modified, consistent with our determination that a set-aside be provided for United States government claims.

LOSS ADJUSTMENT EXPENSES

No less than fifteen claimants have objected to the Plan's provision for the equal sharing of loss adjustment expenses by Mutual Fire and its policyholders as of April 1, 1989.

We are painfully aware of the magnitude of this—the largest current expense of the estate—and of the drain it causes on Mutual Fire's resources. Most, if not all, of the retainers and employment agreements were negotiated by Mutual Fire or its authorized agents prior to its suspension and rehabilitation. It stands to reason that those persons did not have the same incentive to economize which representatives of an insolvent estate necessarily possess. Everyone now, though, must recognize the changed circumstances which have led to this rehabilitation proceeding.

Notwithstanding these changed conditions, in order to minimize the possibility of prejudice to the policyholders whose claims Mutual Fire is obligated to defend, we will modify Section IX of the Plan and direct that loss adjustment expenses be shared equally as provided in the Plan, but not until ninety days from the date of the Order entered today. We extend the date for

the reduction of full payment of loss adjustment expenses in order to minimize any adverse consequences on the defense of claims.

At the same time, we will further Order the Rehabilitator to review *all* employment and retainer agreements, including those of outside counsel and consultants employed with the Court's approval, with the aim toward renegotiation, where appropriate, and reduction of fees and expenses. It is obvious, though worth repeating, that each dollar expended in administrative and unreinsured loss adjustment costs and fees is a dollar taken away from the payment of claims. We therefore view this as a task of vital importance to the insureds and claimants and require that it be undertaken forthwith.

PROPORTIONAL PAYMENTS METHOD

The Rehabilitator proposes,[14] as part of the Plan's proportional payment methodology, to make the first distribution to pay "small claims"—those of $5,000 and under—"as soon as practicable following the effective date of this Plan." We view this innovation an effective and expeditious means of carrying out the Rehabilitator's statutory mandate and find it to be an "equitable apportionment of unavoidable loss." Consequently, we approve it but with the following modifications.

We will require the Rehabilitator to make payments under this distribution no later than June 1, 1990. We will also require the Rehabilitiator to submit a schedule of payments made under this provision of the Plan and direct her to establish a schedule of distribution dates

[14] This proposal was also embodied in the Rehabilitator's motion for authority to pay small claims filed August 11, 1989.

which she deems appropriate. Additionally, we will modify the Plan so that payment of these small claims to single persons or entities with more than one claim shall be taken into account in the proportional payment program. We agree with the Policyholders Committee that this latter modification will minimize the preference otherwise given to policyholders with multiple small claims.

The Policyholders Committee also urged us to allow small claims payment only to those claims *not adjusted* as of the Plan approval date. Underlying this argument is the rationale that immediate adjustment and payment of small claims will save the estate costs concomitant with the continuing management of the outstanding, unadjusted claims. While this rationale applies in part to the Rehabilitator's proposed methodology, we believe such a distinction is inequitable and punishes those claimants who have thus far cooperated with the estate by resolving disputes and settling claims during the pendency of these proceedings. We will, therefore, approve the payment of small claims whether adjusted or unadjusted as of this date.

MISCELLANEOUS PROVISIONS

A. *Jurisdictional Statement*

Article V defines the Commonwealth Court's jurisdiction. "No court of this Commonwealth shall have jurisdiction to entertain, hear or determine any delinquency proceeding other than as provided in this article." Section 504 of the Act, 40 P.S. §221.4.

The statute contemplates that the Commissioner shall petition this Court for rehabilitation and thereafter be appointed statutory rehabilitator. 40 P.S. §221.15.

The Commissioner, as Rehabilitator under the Court's supervisory aegis, is empowered to "pursue all appropriate legal remedies on behalf of the insurer." 40 P.S. §221.16(c).

In any court in this state before which any action is pending when a rehabilitation order is entered, the Rehabilitator may request a stay. 40 P.S. §221.17(a). This Court then shall order the Rehabilitator to take such action in that "pending litigation as the court deems necessary . . . ." In addition, the Rehabilitator is directed "to consider all litigation pending outside this Commonwealth and shall petition the courts having jurisdiction over that litigation for stays whenever necessary . . . ." *Id.*

Thus, the plain language of the statute provides for the Commonwealth Court's exclusive jurisdiction over delinquency proceedings themselves, while recognizing that other courts have jurisdiction over pending proceedings by or against an estate in rehabilitation. Although the Rehabilitator refers us to decisions in other jurisdictions which found an *implied* grant of exclusive jurisdiction to the receivership court,[15] we are not permitted to ignore the statute's plain language in a search for legislative intent.

We disagree with the Rehabilitator that the jurisdictional provision contained in the present Plan is nearly identical to that the Court approved on May 18, 1987. Sections VIII (c) and (e) differ in material respects and we will strike them in whole or in part. Sections (a),

[15] *In the Matter of Allcity Insurance Co.*, 413 N.Y.S. 2d 929, 66 A.D.2d 531 (1979), and *United States v. Bank of New York & Trust Co.*, 296 U.S. 463 (1936) (adopting New York Court's construction of state law in *People by Beha v. Russian Reinsurance Co.*, 255 N.Y. 415, 175 N.E. 114 (1931).

(b), (d), (f) and (g) comport with Article V's grant of exclusive jurisdiction in *delinquency* proceedings because they invoke our exclusive jurisdiction in this Commonwealth over matters connected to interpretation of the Plan—and implementation of the rehabilitation itself—including its provisions for asset collection and claims disputes. We therefore approve them.

Likewise, we approve Section X.A, governing disputes other than claims subject to arbitration. We construe this section as permitting parties to a dispute to *request* Commonwealth Court resolution in lieu of arbitration.

B. *Committee Dissolution*

The Rehabilitator has in the Plan proposed that the Policyholders Committee appointed January 28, 1987, by the Court be dissolved.[16] This Court, by Order of November 22, 1989, so dissolved the Committee.

Notwithstanding the Committee's argument that policyholders as a class would thereby be without representation, we took this action for the following reasons.

Primarily, the rehabilitation statute conveys to the Rehabilitator the authority and the *duty* to protect the interests of Mutual Fire's insureds. 40 P.S. §221.1(c). The Rehabilitator has taken possession of Mutual Fire's assets and, by her deputies, continues to administer its business and property, "under the orders of the Court." 40 P.S. §221.15(c). In instances where she deemed it

[16] The Rehabilitator by motion of April 6, 1989, had previously asked this Court to suspend payment of the Policyholders Committee's counsel fees and costs. Because of our determination of this Plan provision, we will now dismiss this motion as supererogatory.

necessary she has pursued (and will pursue) litigation on behalf of Mutual Fire. She has now proposed a Plan which upon examination and as modified, we find gives due consideration to Mutual Fire's policyholders and other creditors as well.

In addition, the Rehabilitator has petitioned for the establishment of a program to pay outstanding claims under $5,000; a provision for "hardship" claims; and a proportional payment methodology. These procedures, as now modified in the Plan, will protect those policyholders (and claimants) with little or no recourse except to Mutual Fire insurance. Thus, the most damaging exposure to small, "mom and pop" policyholders has been minimized. As the Policyholders Committee has repeatedly stated in its numerous motions and briefs, the rationale underlying its existence and functions is to protect the policyholder class.

Thus, we conclude that the need this Court perceived when equitable considerations dictated the Policyholders Committee's formation no longer exists. Consequently, we find that this cost to Mutual Fire's diminished estate can no longer be justified.

Moreover, dissolution of the Committee does not leave policyholders unrepresented. As we have stated, the Rehabilitator is statutorily charged with that duty. Moreover, dissolution of the Policyholders Committee means only that this Court will not authorize payments of its costs and fees from Mutual Fire's estate. The Policyholders Committee may, as it sees fit, continue its activities outside the Court's aegis, as have the other creditors' groups known as the "lender group" and "cedents' group." Of course, individual policyholders also continue to have an opportunity to be heard.

Accordingly, we approve Section XVI.I of the Plan.

C. *Immunity Provision*

Because no provision for immunity contained in the Plan can *in any case* confer upon the Rehabilitator, her deputies or agents immunity greater than that given by Pennsylvania law as codified in Sections 8501—8528 and 8541—8564 of the Judicial Code, 42 Pa. C.S. §§8501—8528; 8541—8564, we will strike this section of the Plan as supererogatory. We emphasize that we do not by this action decide the question of the Rehabilitator's immunity.

D. *Indemnification Agreement*

The Policyholders Committee has also, by separate motion,[17] sought disapproval of certain employment agreements which the Rehabilitator has entered into in connection with her powers under 40 P.S. §221.16(a) and (b). The Policyholders Committee would have us disapprove the employment of more than one deputy and strike those parts of any agreements containing indemnification provisions for appointed deputies and other employees.

However, the above-mentioned section of Article V gives the Rehabilitator express power to "appoint a special deputy who shall have all the powers of the rehabilitator" and who shall "serve at the pleasure of the commissioner." In addition, the Rehabilitator "shall have full power to direct and manage, to hire and discharge employes . . . ." We do not find it unreasonable or arbitrary that the Rehabilitator has chosen to appoint a deputy and an "assistant special deputy" to implement a rehabilitation and to manage an estate of this magnitude.

[17] Policyholders Committee Objection, March 9, 1989.

Next, the Policyholders Committee refers to authority which it argues would require us to find indemnification agreements between the Rehabilitator and her deputies void as against public policy. Relying on *Hodgson's Estate*, 342 Pa. 250, 20 A.2d 294 (1941), and *Dilks v. Flohr Chevrolet*, 411 Pa. 425, 192 A.2d 682 (1963), the Policyholders Committee maintains that the indemnity contract to which it objected cannot be entered into because its terms exempt one charged with public service from liability. We find the Committee's arguments unpersuasive in this rehabilitation context, however.

First, *Hodgson's Estate* decided issues raised in testamentary trust litigation. While there is some analogy between an executor or administrator and the Rehabilitator's deputies in this rehabilitation, it has been noted that a receiver's possession of assets is not precisely that of a trustee, but is merely a figurative way of stating that the receiver must hold the property for the benefit of others, albeit in a fiduciary capacity.[18]

We also note that *Miller v. Jacobs*, 361 Pa. 492, 65 A.2d 362 (1949), another testamentary estate decision on which the Policyholders Committee relies, stated the general rule that estate administrators are liable individually but "[w]hether the executor or administrator may have *indemnity* out of the estate is of no concern to third persons." *Id.* at 495 n. 1, 65 A.2d 364 n. 1 (emphasis added).

Nor does *Dilks* stand for the proposition that *exculpatory* clauses, which may be voided as against policy, *Boyd v. Smith*, 372 Pa. 306, 94 A.2d 44 (1953), and *indemnity* provisions receive the same treatment

[18] Couch on Insurance 2d (Rev. ed. 1984) §22:45.

under Pennsylvania law. Rather, we find persuasive the Third Circuit's reasoning in *Jamison v. Ellwood Consolidated Water Co.*, 420 F.2d 787, 789 (3d Cir. 1970):

> The difference between . . . [exculpatory clauses and indemnity agreements] is manifest and significant. A valid exculpatory clause precludes recovery by the victim of the negligence. In contrast, a valid indemnity provision in no way affects the victim's right of recovery. . . . The Dilks opinion shows an awareness that indemnity and exculpatory clauses are sufficiently similar that the same rules of construction may often be used. However, Dilks clearly did not go so far as to say that the public policy considerations determinative of the legality of exculpatory clauses are necessarily determinative of the legality of indemnity clauses.

On the contrary, the Rehabilitator's action in agreeing to indemnity is reasonably related to public policy considerations governing insurance company rehabilitation.

The necessity of finding experienced and competent deputies is recognized by the statute. "The commissioner shall make such arrangements for compensation as are necessary to obtain a special deputy of proven ability." 40 P.S. §221.16(a).

In order to attract persons of proven ability, that necessity dictates that those persons be somehow insulated from the fears and costs of possible litigation by naturally disgruntled claimants and other creditors who will inevitably suffer some loss. To this end, the Rehabilitator has adopted a reasonable policy of indemnifying her deputies for all actions within the scope of their appointed duties. We therefore by Order of March 17, 1989, approved the Rehabilitator's request for this employment agreement.

CONCLUSION

Having considered all objections and found that the proposed Plan, with modifications, constitutes an equitable apportionment of unavoidable loss, is in the best interests of insureds and other creditors, and does not constitute an abuse of the Rehabilitator's discretion, we modify the Plan consistent with this opinion and approve it in all other respects.

Date: January 23, 1990

/s/ JAMES CRUMLISH, JR.
James Crumlish, Jr.
President Judge

ORDER OF THE COMMONWEALTH COURT OF PENNSYLVANIA

(Dated January 23, 1990)

No. 3483 C.D. 1986

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,
Plaintiff,

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,
Defendant.

ORDER

The Rehabilitator's January 31, 1989 Plan of Rehabilitation in the above-captioned matter is modified as follows:

1. The Rehabilitator shall set aside funds which she deems adequate to satisfy any and all possible debts due to the United States Government from The Mutual Fire, Marine and Inland Insurance Company's (Mutual Fire) estate. The Rehabilitator shall advise the Court when this amount is determined and describe the nature of the potential claims for which funds have been set aside. The Rehabilitator shall also notify the United States Government of its determination.

2. Section II.J. is amended to read:

J. Class 10: Owners, Officers and Directors

To the extent of cash available after full payment of all Class 9 claims, payments shall be made to Policyholders as of December 4, 1986, other than in their capacity as Class 4 claimants, in proportion to the annual premiums for the policies then in force.

3. Section III.D., first paragraph, is amended to read:

Setoff for purposes of this Plan shall be calculated as of December 4, 1986. No setoff shall be allowed or paid in those situations described in 40 P.S. §221.32(b)(1) through (4). Within ninety (90) days of final approval of the Plan, the Department shall notify each creditor of the amount of setoff as calculated by the Rehabilitator. This notice shall contain a statement advising each creditor that it shall have thirty (30) days from receipt of said notice to object to the Rehabilitator's calculation, or that calculation shall be deemed final. In the event of an objection, the dispute shall be resolved pursuant to the Claim Resolution Procedures set forth in Section VII of this Plan.

4. Section III.E.2. is amended to read:

a. Mutual Fire's obligation to the Cedent for: balances Due and Owing, plus reported Case Reserves, plus reported IBNR.

All as computed as of December 4, 1986; or

b. The Cedent's obligation to Mutual Fire for: balances Due and Owing, plus Case Reserves.

All as computed as of December 4, 1986.

Mutual Fire's IBNR is specifically excluded from section (b.) of this calculation.

To the extent that Case Reserves are set off and the claims relating to those case reserves ultimately are settled at a value less than the reserved amount, Reinsurer who is also a Cedent shall remit, in cash, the balance to Mutual Fire.

5. Section III.F. of the Plan is stricken in its entirety.

6. Section VI.A. is amended to read:

Interim Partial Payments

Interim Partial Payments shall be made periodically on Class 4 adjusted claims (Policyholder Loss Claims and Guaranty Association Loss Claims) as each is available, in the manner set forth below.

1. The first distribution to Class 4 shall be made as soon as practicable following the effective date of this Plan, but no later than December 1, 1990. The Rehabilitator shall pay after the effective date Class 4 claims of $5,000.00 or less per adjusted claim as and when adjusted out with the first payment not later than June 1, 1990.

2. Unless otherwise Ordered by the Court, distributions shall thereafter be made to Class 4 adjusted claims at least annually.

3. Payments of Class 4 claims to Class 4 claimants with more than one claim under $5,000.00 shall be treated as advances against distributions under the Proportional Payments Method described herein. No Class 4 claimants who receive payment for multiple small claims shall receive distribution under the Proportional Payment Method until all the Class 4 claimants first receive an equal percentage distribution on their adjusted claims.

7. Section VI.C.1.b. is amended to read:

b. The first distribution respecting claims adjusted between Record Dates ("later-Adjusted Claims") shall cause each such Claim to receive an

amount equal to the cumulative percentage paid on earlier Adjusted Claims so that all Adjusted Claims as of a given Record Date shall receive, on a cumulative basis, proportionally equal distributions as of each Distribution Date.

8. Section VI.C.4. is amended to read:

Upon notice as the Court shall require, all assets held and segregated pursuant to this Section VI by the Rehabilitator, after Class 4 Claims are paid in full or reserved for payment in full, shall be released for payment to Classes 5 through 10.

9. Section VII, second paragraph, is amended to read:

Whenever objections are filed and served, the Rehabilitator shall seek a hearing and give notice of the hearing by first class mail to the Claimant or its attorney not less than thirty (30) days before the date of the hearing. The matter may be heard by the Court or by a court-appointed referee or master who shall submit findings of fact along with his recommendation. Claimants shall cooperate with the Rehabilitator in an effort to settle and adjust Claims.

10. Section VIII.(c) is modified to read:

(c) to hear, determine and where appropriate refer to arbitration, all disputes concerning Claims and the collection of assets of Mutual Fire, including reinsurance and retrocessions;

11. Section VIII(e) is stricken.

12. Section XIII.B. is amended to read:

No action at law or equity shall be brought against Mutual Fire or the Rehabilitator or any employee, agent or representative of the Rehabilitator, whether in the Commonwealth of Pennsylvania or elsewhere, nor shall any such existing actions be maintained or further

prosecuted, nor shall any counterclaim or staff be asserted in any action brought by or on behalf of the Rehabilitator, whether in Pennsylvania or elsewhere, except as permitted under the terms of this Plan or by the Courts.

The last sentence of Section XIII.B. is stricken.

13. Section XVI.B. is amended to read:

B. Financial Reports

The Rehabilitator shall submit to the Court an annual budget for each year. The Rehabilitator shall also file quarterly financial reports with the Court showing Mutual Fire's current financial condition, a balance sheet, an income statement, a cash flow statement, a statement of operating and administrative expenses. The Rehabilitator shall also file status reports on reinsurance and asset collections, claims reported and adjusted, and such supporting schedules as are necessary to present Mutual Fire's financial condition fairly.

14. The Plan, including each provision except where amended by this Order, is approved in all other respects.

Date: January 23, 1990

/s/ JAMES CRUMLISH, JR.
James Crumlish, Jr.
President Judge

ORDER OF THE COMMONWEALTH COURT OF PENNSYLVANIA

(Dated February 13, 1990)

No. 3483 C.D. 1986

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,
Plaintiff,

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,
Defendant.

O R D E R

AND NOW, this 13th day of February, 1990, it is ordered that the opinion filed January 23, 1990, shall be designated OPINION rather than MEMORANDUM OPINION and that it shall be reported.

/s/ JAMES CRUMLISH JR.
James Crumlish, Jr.
President Judge

CERTIFIED FROM THE RECORD
AND ORDER EXIT
FEB 13 1990
CR. Hostetler
Deputy Prothonotary—Chief Clerk

ORDER OF THE COMMONWEALTH COURT OF PENNSYLVANIA

(Dated February 26, 1990)

No. 3483 C.D. 1986

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,
Plaintiff,

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,
Defendant.

ORDER

NOW this 26th Day of February, 1990, this Court's Order of January 23, 1990, is hereby amended as follows:

Paragraph No. 6 of said Order is amended to read:

> Interim Partial Payments shall be made periodically on Class 4 adjusted claims (Policyholder Loss Claims and Guaranty Association Loss Claims) as cash is available, in the manner set forth below.

Paragraph No. 12 of said Order is amended to read:

> No action at law or equity shall be brought against Mutual Fire or the Rehabilitator or any employee, agent or representative of the

Rehabilitator, whether in the Commonwealth of Pennsylvania or elsewhere, nor shall any such existing actions be maintained or further prosecuted, nor shall any counterclaim or setoff be asserted in any action brought by or on behalf of the Rehabilitator, whether in Pennsylvania or elsewhere, except as permitted under the terms of this Plan or by the Courts.

Paragraph No. 11(A) is hereby added to said Order.

11(A). The second paragraph of Section IX Loss Adjustment Expenses is amended to read:

Loss Adjustment Expenses related to the employment of all investigators, adjustors and counsel who are retained by the Rehabilitator or Mutual Fire or either of their authorized agents to investigate, adjust and defend Claims asserted against Mutual Fire's Policyholders ("Professionals") shall be shared equally by Mutual Fire and its Policyholders effective April 23, 1990. The Rehabilitator reserves the right to further reduce or terminate payment of Loss Adjustment Expenses in the event that cash flow is inadequate. Loss Adjustment Expenses will be paid as aforesaid by Mutual Fire only if Policyholders pay their share of Loss Adjustment Expenses and retain the services of Professionals previously approved or hereafter approved by the Rehabilitator.

/s/ JAMES CRUMLISH, JR.
James Crumlish, Jr.
President Judge

CERTIFIED FROM THE RECORD
AND ORDER EXIT
FEB 26 1990
C.R. Hostetler
Deputy Prothonotary—Chief Clerk

ORDER OF THE COMMONWEALTH COURT OF PENNSYLVANIA

(Dated April 18, 1990)

No. 3483 C.D. 1986

IN THE COMMONWEALTH COURT
OF
PENNSYLVANIA

GEORGE F. GRODE, INSURANCE COMMISSIONER OF THE COMMONWEALTH OF PENNSYLVANIA,
Plaintiff,

v.

THE MUTUAL FIRE, MARINE AND INLAND INSURANCE COMPANY,
Defendant.

ORDER

Upon consideration of the applications of the Rehabilitator and various other parties for clarification of this Court's January 23, 1990 Order, said Order is amended to conform with this Court's direction that all provisions on the conclusiveness of Mutual Fire's books and records contained in the Rehabilitator's Modified Plan of Rehabilitation be stricken.

The sentence, "Balances set forth on the books of Mutual Fire shall be conclusive for this purpose." is hereby stricken from Sections III, E.1 and III, G. of the Rehabilitator's Modified Plan of Rehabilitation.

Date: April 18, 1990

/s/ JAMES CRUMLISH, JR.
James Crumlish, Jr.
President Judge

CERTIFIED FROM THE RECORD
AND ORDER EXIT
APR 18 1990
C.R. Hostetler
Deputy Prothonotary—Chief Clerk

PLAN OF REHABILITATION FILED IN THE COMMONWEALTH COURT OF PENNSYLVANIA

No. 3483 C.D. 1986
(Proceedings For Rehabilitation
Of A Domestic Insurer)

IN THE COMMONWEALTH COURT
OF PENNSYLVANIA

GEORGE F. GRODE, Insurance
Commissioner of the
Commonwealth of Pennsylvania,
Plaintiff,

v.

THE MUTUAL FIRE, MARINE &
INLAND INSURANCE COMPANY,
Defendant.

PLAN OF REHABILITATION
January 31, 1989

This Modified Plan of Rehabilitation is proposed pursuant to 40 P.S. Section 221.16(d) by Constance B. Foster, Insurance Commissioner of the Commonwealth of Pennsylvania, as Rehabilitator of The Mutual Fire, Marine & Inland Insurance Company (the "Plan"). The Plan supersedes all previous plans of rehabilitiation proposed and/or confirmed, supersedes any prior inconsistent Orders or agreements and governs the payment and satisfaction of all rights and Claims against the assets of Mutual Fire of all persons interested in the Rehabilitation of Mutual Fire. Such parties shall have no rights or Claims against the assets of Mutual Fire other than as are provided by the Plan.

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[1]

SECTION I.
DEFINITIONS

For purposes of this Plan, and unless the context otherwise requires, the terms set forth below shall have the following meanings:

1. *Adjusted Claim.* A Loss Claim against Mutual Fire that has been approved by the Rehabilitator or the Courts, or through the claim resolution procedures set forth in Section VII.

2. *Administrative Claims.* The costs and expenses of administration, including but not limited to the following: the actual and necessary costs of preserving or recovering the assets of Mutual Fire; compensation for all services rendered in the Rehabilitation; any necessary filing fees; the fees and mileage payable to witnesses; reasonable attorneys' fees, including provisions of any employment agreements entered into by the Rehabilitator.

3. *Case Reserves.* The aggregate estimated amounts of Claims reported but not adjusted in accordance with Section VII.

4. *Cedent.* An entity reinsured under a contract or agreement of Reinsurance Written by Mutual Fire.

5. *Claim.* The assertion of a right to payment from Mutual Fire, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured; or, the right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

6. *Claimant.* A person or entity making a Claim.

7. *Court.* The Commonwealth Court of Pennsylvania.

8. *Creditor.* The holder of a Claim.

[2] 9. *Deficiency Claim.* The amount of the Claim of a Secured Creditor less the value of said Claimant's interest in Mutual Fire's interest in property securing said Claim.

10. *Distribution Date.* A date on which interim partial payments are made under the Proportional Payments Method with respect to Adjusted Claims.

11. *Due and Owing.* Reinsurance recoverable on paid Losses, paid Loss Adjustment Expenses, Claim settlements and reimbursement agreements.

12. *Effective Date.* The date on which this Plan is approved by final Order, which Order is not subject to a motion for reconsideration or an appeal and for which the time to seek reconsideration or file an appeal has expired.

13. *Estimation Margin.* A Claims category established under the Proportional Payments Method representing the estimated potential for error in ascertaining reserves due to adverse loss development and other factors, relevant to estimates of Case Reserves and IBNR.

14. *Guaranty Association.* A state insurance Guaranty Association or security fund that is obligated by law to pay certain covered claims arising under Mutual Fire's insurance policies pursuant to applicable state law.

15. *Incurred But Not Reported ("IBNR") Losses.* Losses that have occurred but have not been reported, and development of reported Claims, the estimated amount of which has been statistically

determined by independent actuaries based on data regarding the history of Mutual Fire's losses and insurance industry data.

16. *Loss(es), Loss Claim(s).* A Claim other than a Claim of a Cedent or Surety Bond Lender arising out of an event covered by a policy of insurance issued by Mutual Fire.

17. *Loss Adjustment Expenses.* Attorneys fees, claims adjuster expenses, and similar expenses relating to adjustment of Claims covered by policies of insurance issued by Mutual Fire and incurred in connection with the adjustment of Losses occurring thereunder.

[3] 18. *Mutual Fire.* The Mutual Fire, Marine & Inland Insurance Company and its estate.

19. *Petition Date.* The date of the filing of the Petition for Rehabilitation of Mutual Fire, December 4, 1986.

20. *Plan.* This Modified Plan of Rehabilitation, all exhibits thereto, and any modifications or amendments thereof.

21. *Policyholder.* An insured under a policy of insurance issued by Mutual Fire, that afforded coverage during the period or periods that such policy was or is in effect, excluding Surety Bond Lenders, Cedents and Reinsurers.

22. *Proportional Payments Method.* The method by which Policyholder Loss Claims will be paid or reserved, in part, from time to time, under Section VI of the Plan.

23. *Record Date.* The date by which Policyholder Loss Claims must be adjusted, as shown by Mutual Fire's records, to qualify for interim partial payments under the Proportional Payments Method on the next Distribution Date.

24. *Rehabilitator.* Constance B. Foster, Insurance Commissioner of the Commonwealth of Pennsylvania, in her capacity as Rehabilitator of The Mutual Fire, Marine & Inland Insurance Company, and any of her successors and/or Deputies.

25. *Reinsurance.* A financial obligation under a contract to assume all or part of a risk or risks insured or reinsured by any insurer or Reinsurer. For purposes of this Plan, reinsurance shall include Retrocessions.

26. *Reinsurer.* An entity obligated under a contract of Reinsurance. For purposes of this Plan, Reinsurer shall include Retrocessionaire.

27. *Retrocession.* The reassigning or ceding by a Reinsurer to another insurance company of all or part of the risks assumed.

28. *Retrocessionaire.* The assuming party to a Retrocession.

29. *Secured Cedent.* A Cedent that is the beneficiary of a letter of credit or trust securing Mutual Fire's Reinsurance obligation or a part of it to that Cedent.

[4] 30. *Secured Claim.* A Claim of a Creditor against Mutual Fire secured by a lien on property, a letter of credit or a trust fund in which Mutual Fire has an interest but only to the extent of the interest of Mutual Fire in said property after deduction of the amount of all prior liens.

31. *Secured Creditor.* Any Creditor that holds a Secured Claim.

32. *Surety Bond.* A financial guaranty contract or performance bond contract issued by Mutual Fire to secure repayment of loans made to finance investment in a real estate limited partnership, an oil and gas limited partnership, or other investment program or guarantying performance.

33. Surety Bond Lender. A Claimant that asserts a Claim under a Surety Bond.

34. *Third Party Loss Claim.* A Claim under a Mutual Fire liability policy asserted by a Claimant other than a Policyholder.

35. *Unsecured Claim.* Any Claim that is not a Secured claim or a cost of administration Claim.

36. *Unsecured Creditor.* The holder of an Unsecured Claim.

[5] SECTION II.
CLASSIFICATION AND TREATMENT OF CLAIMS

A. Class 1: Secured Claims

Each Secured Claim shall be paid to the extent of the value of the collateral which secures said Claim or by the release to the Secured Creditor of collateral equal to the amount of such Secured Claim. Any collateral held by a Secured Creditor in excess of the amount to which said Secured Creditor is entitled pursuant to this Plan shall be turned over to the Rehabilitator. Deficiency Claims shall be classified and treated as Unsecured Claims under Class 6.

1. *Secured Cedents.* A Cedent whose Claim is secured by a letter of credit or a trust shall be permitted to draw upon the letter of credit or trust funds only in such amounts as are due, without acceleration, from Mutual Fire for paid Losses and paid Loss Adjustment Expenses reported to Mutual Fire of such Cedent as approved by the Rehabilitator or the Court. Deficiency Claims of such Cedents shall be classified and treated as Unsecured Claims under Class 6. Investment earnings from Mutual Fire assets which are collateral that secures

letters of credit or trust obligations to a Cedent or which are otherwise held in trust shall continue to accrue to the benefit of Mutual Fire's estate.

2. *Financial Institutions.* Financial institutions that hold assets of Mutual Fire in trust or as collateral to [6] secure obligations under letters of credit shall, as approved by the Rehabilitator or the Court, liquidate collateral only in amounts necessary to cover proper draws against such trust funds and letters of credit, or as necessary to discharge obligations of a trustee or Secured Creditor. Deficiency Claims of financial institutions shall be classified and treated as Unsecured Claims under Class 6. Investment earnings on Mutual Fire assets which are collateral held by financial institutions shall continue to accrue to the benefit of Mutual Fire's estate. Any excess collateral under a letter of credit or trust shall be returned to the Rehabilitator forthwith.

B. Class 2: Administrative Claims

Administrative Claims shall be reserved and paid in full and in cash not later than the Effective Date, and from time to time thereafter, as provided in Secion XI of this Plan.

1. *Mutual Fire's Administrative Claims.* Administrative Claims shall include, but not be limited to, the actual, reasonable, and necessary costs of preserving or recovering the assets of Mutual Fire and the costs of goods and services provided to Mutual Fire's estate, including the fees and expenses of professionals approved by the Court. The fees and expenses of outside counsel shall be subject to initial review by the Rehabilitator and subject to final review and approval by the Court.

2. *Guaranty Association Expenses.* The actual, reasonable, and necessary expenses (other than Loss Adjustment [7] Expenses) of a Guaranty Association which are afforded administrative priority under law shall be paid in full from time to time as allowed by the Court after review.

C. Class 3: Wage Claims

Wages due to employees (excluding officers and directors) of Mutual Fire, not to exceed $1,000 per employee, for services actually performed within one year prior to the Petition Date shall be paid in full and in cash on the Effective Date. Any other Claims of Employees shall be classified and treated as Unsecured Claims under Class 6. Claims of officers and directors of Mutual Fire shall be classified and treated under Class 10.

D. Class 4: Policyholder Loss Claims.

1. After Classes 2 and 3, the following Loss Claims, without distinction or subclasses among them, shall be accorded the first priority of distribution among Unsecured Creditors:

a. Adjusted Claims for reimbursement of amounts actually expended by Policyholders for Losses incurred under policies, including reasonable Loss Adjustment Expenses actually expended, to the extent covered by a policy.

b. Adjusted Claims for Losses incurred but not paid by Policyholders under first party property or other policies and under liability policies, including reasonable Loss Adjustment Expenses actually incurred, to the extent covered by a policy.

[8] c. Adjusted Claims for Third Party Loss Claims for amounts owed to Claimants (other than Cedents and Su[illegible]nd Lenders) under laws that permit direct rights of action against Mutual Fire, as permitted and to the extent covered by a policy.

2. Class 4 Claims shall be paid according to the Proportional Payments Method described in Section VI of the Plan.

3. Except for Claims of Guaranty Associations qualifying in Class 2 (administrative expenses), Guaranty Associations that properly pay Claims in accordance with applicable state law shall be subrogated to Claims they have paid and shall be accorded the same priority and treatment as those Claims would have had under Class 4, if not paid by a Guaranty Association.

4. Claims of Policyholders for unearned premiums and subrogated claims of Guaranty Associations for unearned premiums paid by Guaranty Associations shall be classified and treated as Unsecured Claims under Class 6.

E. Class 5: Surety Bond Lenders

1. The amounts of unsecured Surety Bond Lender Claims that cannot be satisfied through reasonable efforts of the Surety Bond Lenders to collect defaulted loans shall be determined by the Rehabilitator and satisfied from such assets of Mutual Fire, other than the Class 6 Fund, as may be available after Claims of Classes 2 through 4 are paid or reserved for [9] payment in full provided, however, that the Surety Bond Lender has neither released, satisfied, waived, prejudiced, extinguished or otherwise modified in any manner whatsoever, the subrogation rights of Mutual Fire to recover any such deficiencies or collect the unpaid

balance of any Note directly from the partnership, the individual defaulted investors, assignees or other third parties, which right Mutual Fire would have had pursuant to the Surety Bond, or otherwise.

2. All Claims of Surety Bond Lenders shall be net of any recoveries and no payments shall be made to Class 5 Claimants without satisfactory documentary evidence of the validity of the Claim. Any Surety Bond Lender making a Claim against Mutual Fire shall submit a complete accounting to the Rehabilitator of all monies received, the date of all such payments and the source, which accounting shall include payments made by Mutual Fire. Surety Bond Lenders shall periodically update their accountings. The Rehabilitator shall retain the right to review and contest the reasonableness of settlements and collections made by Surety Bond Lenders.

3. Class 5 Claims shall be paid in full before any distributions are made with respect to Class 6 Claims except that the Class 6 Fund shall be used for the exclusive benefit of Class 4 or Class 6 Claimants pursuant to the provisions of Section II F, below.

4. No interest shall accrue on Claims of Surety Bond Lenders after June 13, 1986.

[10] F. Class 6: General Unsecured Claims

The claims of general Unsecured Creditors in Class 6 shall include all Claims other than Claims included in Classes 1, 2, 3, 4, 5, 7, 8, 9 and 10. Class 6 Claims shall be paid in full to the extent of cash available after full payment has been made to or provided for Classes 2, 3, 4, and 5.

1. *Creation of Class 6 Fund.* On or before the Effective Date, a segregated account (the "Class 6 Fund") shall be established by the Rehabilitator. The Class 6 Fund shall be funded by depositing in the Class 6 Fund, from time to time, twenty-five percent (25%) of all Reinsurance collected by Mutual Fire, with respect to the assumed reinsurance business of Mutual Fire. All interest earned shall be transferred to the general account of the Rehabilitator and used by the Rehabilitator as a general unliened asset of the estate of Mutual Fire.

2. *Distributions to Class 6 Claimants.* Distributions from the Class 6 Fund shall be made in the discretion of the Rehabilitator following the date upon which the Court enters an Order authorizing an initial distribution to Class 6 Claimants (the "Initial Distibution Order"). The amount of, and mechanics for, such distributions shall be determined by the Rehabilitator. No portion of the Class 6 Fund shall be used for the payment of Class 5 Claims unless and until such time as all Class 6 Claims have been paid in full.

[11] 3. *Surplus.* In the event that all Class 6 Claimants have been paid or provided for in full, the Rehabilitator may, with the approval of the Court after notice and hearing, withdraw the surplus from the Class 6 Fund for payment to other Claimants under this Plan.

4. *Initial Distribution Order.* No distributions to Class 6 Claimants may be made until the Court has entered the Initial Distribution Order. The Initial Distribution Order shall be entered only after motion requesting such relief and only after notice, hearing and the Court's determination that sufficient funds have been collected to pay all Administrative Claims and to pay or reserve for all Class 4 Claims under the Proportional Payment Method.

G. Class 7: Claims of the Federal or any State or Local Government

Claims of the Federal, any state or local government or agencies of any of the foregoing shall be paid in full to the extent of cash available after full payment of all Class 6 Claims.

H. Class 8: Late Claims

Loss Claims reported after June 30, 1991 ("Late Claims") shall be paid in full to the extent of cash available after full payment of all Class 7 Claims. No cutoff date for the reporting and filing of Late Claims is fixed herein. The right is reserved to the Rehabilitator to seek, at a later date, Court approval of a cutoff date for the reporting and filing of Late Claims.

[12] I. Class 9: Holders of Surplus and Contribution Notes

To the extent of cash available after full payment of all Class 8 Claims, payment shall be made in full to such holders of surplus or contribution notes or similar obligations as may exist.

J. Class 10: Owners, Officers and Directors

To the extent of cash available after full payment of all Class 9 Claims, payments shall be made to Policyholders as of December 4, 1986, other than in their capacity as Class 4 and Class 5 Claimants, in proportion to the annual premiums for the policies then in force. The Claims of Officers and Directors of Mutual Fire shall be included in this Class 10.

[13] SECTION III.
SETOFF

Regardless of any provision in a reinsurance contract or other agreement, mutual debts and credits between Mutual Fire and other persons may be setoff on the following basis:

A. Mutual Debts and Credits

Mutual debts and credits may be setoff only on a company by company basis. For purposes of the Plan, a company shall mean a corporation or other legal entity with independent legal existence, capable of suing and being sued in its own name.

Except as hereinafter provided, mutual obligations may not be aggregated and setoff against each other. If the net amount is owed to Mutual Fire by the other company, it shall be paid forthwith to Mutual Fire in full. If the net amount is owed by Mutual Fire, that amount may be claimed according to the priorities of distribution described in Section II of this Plan.

B. Other Obligations

Regardless of any provision in a reinsurance contract or other agreement, obligations to pay premiums to Mutual Fire may not be setoff against other obligations. Premiums owed to Mutual Fire shall be paid forthwith in full.

[14] C. Criteria

Claims are mutual if they satisfy the following criteria:

1. To be mutual, Claims must be mutual at the time the obligations were incurred.

2. Claims do not become mutual by assignment, by reorganization of companies, or by any other means, if the result would be to permit setoff that otherwise would not be available absent such assignment, reorganization or other means.

3. Claims are mutual only if the parties are acting in the same capacity with respect to the Claims they seek to setoff.

D. Setoff Calculated As of December 31, 1986

Setoff for purposes of this Plan shall be calculated as of December 31, 1986. Balances set forth on the books of Mutual Fire shall be conclusive.

The only mutual debts and credits that may be setoff against one another are those Due and Owing on December 31, 1986.

To the extent any Reinsurer who is also a Cedent is permitted a setoff, Mutual Fire shall receive all payments due from the Retrocessionaries that are attributable to the Claims of the ceding company that are satisfied by application of the setoff, and such sums shall not be deposited in the Class 6 Fund.

[15] E. Election of Optional Setoff Definition

1. *Election.* A Reinsurer who is also a Cedent may pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan, in which event the Optional Setoff Definition set forth below shall apply to said Reinsurer. Balances set forth on the books of Mutual Fire shall be conclusive for this purpose.

2. *Optional Setoff Definition.* The Optional Setoff Definition shall be as follows:

Any Reinsurer of Mutual Fire who is also a Cedent to Mutual Fire will be permitted to setoff the lesser of Mutual Fire's obligations to the Cedent against the Reinsurer's obligations to Mutual Fire according to Mutual Fire's books pursuant to the following calculation:

Option Setoff Calculation—The lesser of:

a. Mutual Fire's obligation to the Cedent for:

balances Due and Owing, plus reported Case Reserves, plus reported IBNR.

All as computed as of March 31, 1986, or

b. The Cedent's obligation to Mutual Fire for:

balances Due and Owing, plus Case Reserves. All as computed as of December 31, 1986.

[16] Mutual Fire's IBNR is specifically excluded from section (b.) of this calculation.

To the extent that Case Reserves are setoff and the Claims relating to those Case Reserves ultimately are settled at a value less than the reserved amount, Reinsurer who is also a Cedent shall remit, in cash, the balance to Mutual Fire.

3. To the extent any Reinsurer who is also a Cedent is permitted a setoff, Mutual Fire shall receive all payments due from the Retrocessionaries that are attributable to the Claims of the ceding company that are satisfied by application of the setoff and such sums shall not be deposited into the Class 6 Fund.

F. Maximum Allowable Setoff

The total of all allowable setoff under this Section III shall not exceed $25,000,000. In the event that the total of all allowable setoff exceeds $25,000,000, the Rehabilitator shall adjust the setoff *pro rata*.

G. Reinsurance Discount

Reinsurers who pay that amount carried on the books of Mutual Fire as currently due and owing within ninety (90) days after the date on which the Court enters an Order approving and confirming the Plan shall receive a ten percent (10%) discount. Balances set forth on the books of Mutual Fire shall be conclusive for this purpose. In order to qualify [17] for the discount contained herein, a Reinsurer must waive any right to setoff.

[18] SECTION IV.
MARSHALLING OF ASSETS

A. The Rehabilitator shall collect and liquidate assets including the collection of claims against Reinsurers, and liquidation of personal property (tangible and intangible), and claims against third parties and other claims on an ongoing basis.

B. The Rehabilitator shall adjust Claims on an ongoing basis as provided in Section VII of this Plan.

C. The Rehabilitator shall pay Claims to the extent of Mutual Fire's assets available to pay Claims, in priority of payment as set forth in Section II of this Plan. Except as otherwise provided in this Plan, payment in full shall be made for each Class of Claims before any payments are made on Claims of junior classes.

[19]

SECTION V.
GUARANTY ASSOCIATIONS

A. Distributions to Guaranty Associations

1. Guaranty Associations shall be entitled to reimbursement from the estate in the manner and amount set forth in this Plan for Policyholders and Claimants, only on the basis of actual payments made by the association to or on behalf of said Policyholders and Claimants.

2. In addition to such other information as the Rehabilitator may require, the Guaranty Associations shall be required to submit to the Rehabilitator the following information with respect to each Policyholder and Claimant in their respective states: the name and address of the Policyholder or Claimant; the total amount of the allowed Claim; the total amount paid by the association in reimbursement of the Claim; and the total amount paid by the association in outside lawyer and adjuster fees for the benefit of such Policyholder or Claimant.

B. Distributions to Claimants in Guaranty Fund States

1. A Policyholder or Claimant who is entitled to reimbursement from a Guaranty Association may receive a distribution under this Plan only in those circumstances in which the total percentage of reimbursement which such Policyholder or Claimant has received from the Guaranty Association is less than the percentage of reimbursement distributed to Credi- [20] tors of the same priority under the Plan that do not qualify for Guaranty Association coverage. In such cases, such Policyholder or Claimant may receive such

additional distributions under this Plan as are required to provide such Policyholder or Claimant with a total percentage of reimbursement equal to that received by Creditors of the same priority under the Plan who are not eligible for reimbursement from Guaranty Associations. In computing the total percentage of reimbursement received by a Policyholder or Claimant from a Guaranty Association, the Rehabilitator shall include and consider any amounts paid by the Guaranty Association on behalf of such Policyholder or Claimant to outside vendors such as independent adjusters and attorneys.

2. There shall be no duplication of payments hereunder to a Guaranty Association and the Policyholders or Claimants subject to reimbursement by such Guaranty Association.

[21] SECTION VI.
PROPORTIONAL PAYMENTS METHOD

A. Interim Partial Payments

Interim partial payments shall be made periodically on Class 4 Adjusted Claims (Policyholder Loss Claims and Guaranty Association Loss Claims) as cash is available, in the manner set forth below.

1. The first distribution to Class 4 shall be made as soon as practicable following the Effective Date of this Plan. The Rehabilitator shall pay after the Effective Date Class 4 Adjusted Claims of $5,000.00 or less per Adjusted Claim as and when adjusted and without regard to the Proportional Payments Method.

2. Unless otherwise ordered by the Court, distributions shall thereafter be made to Class 4 Adjusted Claims at least annually.

B. Available Cash

Cash available to pay Class 4 Claims, after setting aside a reserve for Classes 2 and 3, as directed by the Court from time to time, shall be allocated proportionally among the following categories:

1. Adjusted Claims.

2. Case Reserves and IBNR

3. Estimation Margin.

[22] C. Amounts To Be Allocated

In order to determine the amounts to be allocated, the total amount of Class 4 Adjusted Claims, actuarial estimates of Case Reserves, IBNR and Estimation Margin shall be determined from time to time as of a Record Date. Simultaneously with each Record Date a Distribution Date shall also be fixed not less than sixty (60) days following the Record Date.

1. Claims adjusted on or before each periodic Record Date shall qualify thereafter to receive partial distributions until such time as the Claims are paid in full or Mutual Fire's assets available to pay Class 4 Claims are exhausted, whichever event occurs first.

a. Cash allocated to Adjusted Claims, section VI B. 1., shall be paid to Policyholders and Third Party Loss Claimants in proportion to the amount each Adjusted Claim bears to the cumulative total of all Adjusted Claims on each Record Date.

b. The first distribution respecting Claims adjusted between Record Dates ("later-Adjusted Claims") shall cause each such Claim to receive an amount equal to the cumulative percentage paid on earlier Adjusted Claims

so that all Adjusted Claims as of a given Record Date shall receive, on a cumulative basis, proportionally equal distributions as of each Distribution Date. The first distribution respecting a later-Adjusted Claim may be made by the Rehabilitator at any [23] time after the first Record Date from cash available and allocated pursuant to Sections VI B. 1 and 2.

c. Claimants with Adjusted Claims that already have received a distribution shall not receive a further distribution unless and until sufficient cash is available to pay and reserve for later-Adjusted Claims so that later-Adjusted Claims may receive, on a cumulative basis, proportionally equal distributions.

d. Cash distributions shall be made only with respect to Adjusted Claims.

2. Cash allocated to categories VI B. 2., and 3 (Case Reserves, IBNR, and Estimation Margin) shall be segregated by the Rehabilitator.

3. At each Distribution Date the funds segregated and held by the Rehabilitator, including investment earnings thereon, plus any amount in excess of the reserve for Classes 2 and 3, shall be allocated among the categories of Adjusted Claims, Case Reserves, IBNR, and Estimation Margin, as described above.

4. All assets held and segregated pursuant to this Section VI by the Rehabilitator, after Class 4 Claims are paid in full or reserved for payment in full, shall be released for payment to Classes 5 through 10.

D. Effect of Payments By Guaranty Associations

So long as interim partial payments are made, they shall continue to be made to Guaranty Associations on the [24] same basis as to Policyholders not entitled to

Guaranty Association coverage to reimburse them, on a Claim by Claim basis, for Loss Claims paid by the Guaranty Associations, until the Guaranty Associations are reimbursed in full. No payment shall be made to any Policyholder or Claimant on account of the Guaranty Association deductible. After Guaranty Associations have been reimbursed in full, proportional payments shall be made pursuant to the Proportional Payments Method to Class 4 Claimants paid by Guaranty Associations for any remaining amounts of Loss Claims not satisfied by Guaranty Associations.

E. Annual Review By The Court

At least once each year, the Rehabilitator shall seek Court approval, regarding:

1. The amounts that should be set aside for Claims of Classes 2 and 3;

2. The amounts of available cash that should be segregated;

3. The amounts of Class 4 Claims represented by categories VI B. 1 to 3 (Adjusted Claims, Case Reserves, IBNR and Estimation Margin); and

4. The next Record Date and Distribution Date.

F. Actuarial Analysis

Actuarial analysis of Case Reserves, IBNR, and Estimation Margin shall be made by independent actuaries having experience with property and casualty insurance loss reserves, selected by the Rehabilitator and approved by the Court.

[25] G. Cutoff Date For Submission Of Loss Claims

No Loss Claim (Class 4) which is reported subsequent to June 30, 1991 will be allowed, recognized or paid in Class 4 and all Loss Claims reported subsequent to June 30, 1991 will be barred and disallowed as Class 4 Claims. Loss Claims must be reported to Mutual Fire in writing and date stamped by Mutual Fire. Loss Claims reported to Mutual Fire after June 30, 1991 will be Late Claims and included in Class 8.

The bar date for filing proofs of claim with Mutual Fire for Class 3 Claims and for all Class 6 Claims other than Unsecured Claims of Cedents shall be three (3) months from the date of the Order confirming this Plan.

No cutoff date for the filing of Unsecured Claims of Cedents or Surety Bond Lenders is fixed herein. The right is reserved to the Rehabilitator to seek at a later date Court approval of a cutoff date for the filing of proofs of claim by Unsecured Cedents and Surety Bond Lenders. No Class 3 Claim or Class 6 Claim (other than Unsecured Claims of Cedents) filed after three (3) months from the date of the Order confirming this Plan will be allowed, recognized or paid. Class 3 Claims or Class 6 Claims (other than Unsecured Claims of Cedents) filed after three (3) months from the date of the Order confirming this Plan will be Late Claims and included in Class 8.

Claims, to be allowable, must either be fixed by settlement or judgment on the merits after trial or must be [26] provable to the extent that the proof offered is such that the Claimant would be entitled to obtain a judgment upon such Claim against Mutual Fire. Judgments entered by default will not be recognized or considered binding.

H. Subrogation

Payments of Loss Claims and Loss Adjustment Expenses shall be made notwithstanding, and the timing of such payments shall not be delayed on account of, any claims against or recoveries from third parties by any Policyholder arising out of a loss that is covered under the Policyholder's policy. To the extent that payment is made to a Policyholder under this Plan, Mutual Fire shall be subrogated to all such rights of recovery of the Policyholder against third parties to the extent provided by the applicable insurance policy or by applicable law. This Plan shall not be construed to either enlarge or restrict Mutual Fire's rights of subrogation under any policy of insurance or applicable law.

[27]

SECTION VII.
CLAIM RESOLUTION

The Rehabilitator shall review and adjust all Claims. When a Claim is denied by the Rehabilitator in whole or in part, written notice of the determination shall be given to the Claimant and its attorney, if any, by first class mail at the address shown in the proof of claim. Within sixty (60) days from the date of mailing of the notice, the Claimant may file objections with the Court and serve a copy of any objections on the Rehabilitator and her counsel. If no such filing and service is made, the Claimant may not further object to the determination.

Whenever objections are filed and served, the Rehabilitator shall seek a hearing and give notice of the hearing by first class mail to the Claimant or its attorney not less than ten (10) days before the date of the hearing. The matter may be heard by the Court or by a Court appointed referee or master who shall submit findings of

fact along with his recommendation. Claimants shall cooperate with the Rehabilitator in an effort to settle and adjust Claims.

One or more representatives of Mutual Fire's Reinsurers may (but need not) be appointed by the Court on the recommendation of the Rehabilitator to consult with the Rehabilitator in her review of Claims and in her consideration of settlements, adjustments and reimbursement agreements. Any such represen- [28] tatives shall serve without compensation and shall have no authority to employ professionals or incur expenses.

[29]

SECTION VIII.
JURISDICTION

Pursuant to 40 P.S. 221.4, the Court shall retain exclusive jurisdiction of these proceedings and all matters relating to the implementation and consummation of the Plan. Such jurisdiction shall include, but not be limited to, the following:

(a) to consider any modification or amendment to the Plan;

(b) to hear and determine all controversies, suits and disputes that may arise in connection with the interpretation or enforcement of the Plan;

(c) to hear, determine and where appropriate refer to arbitration, all controversies, suits, and disputes concerning rights and obligations of Mutual Fire or arising out of the business or operations of Mutual Fire relating to any Claim, cause, cause of action, unlawful or improper transfers or transactions, preferences, fraudulent conveyances, and matters relating to agent, agency, Reinsurer and Reinsurance obligations;

(d) to approve, and/or set guidelines for the settlement, commutation, compromise or disposition of any claim against Mutual Fire or any cause, right, or asset (tangible or intangible) of Mutual Fire;

(e) to review decisions, actions, orders, or awards of arbitrartion panels;

[30] (f) to appoint masters, referees and arbitrators as necessary or appropriate to submit findings of fact and recommendations;

(g) to consider and act on any other matter related to the Plan.

[31] SECTION IX.
LOSS ADJUSTMENT EXPENSES

The Rehabilitator shall continue to make payments for all reasonable costs and fees incurred by her or her authorized claim adjustors and agents retained in connection with the adjustment, investigation and defense of claims asserted directly against Mutual Fire.

Loss Adjustment Expenses related to the employment of all investigators, adjustors and counsel who were retained by the Rehabilitator or Mutual Fire or either of their authorized agents to investigate, adjust and defend Claims asserted against Mutual Fire's Policyholders ("Professionals") shall be shared equally by Mutual Fire and its Policyholders effective April 1, 1989. The Rehabilitator reserves the right to further reduce or terminate payment of Loss Adjustment Expenses in the event that cash flow is inadequate. Loss Adjustment Expenses will be paid as aforesaid by Mutual Fire only if Policyholders pay their share of Loss Adjustment Expenses and retain the services of Professionals previously approved or hereafter approved by the Rehabilitator.

The Professionals shall submit to the Rehabilitator invoices for services rendered and reimbursement of expenses incurred.

The Rehabilitator shall review all invoices submitted by the Professionals, which invoices shall include a detailed [32] description of services rendered with rates and time expended and substantiation for expenses for which reimbursement is sought.

The Rehabilitator shall submit to the Court for approval any requests for compensation and reimbursement of expenses of the Professionals as determined by the Rehabilitator to be fair, reasonable and prudent.

The Rehabilitator may seek leave of the Court to pay all Loss Adjustment Expenses for investigators, adjustors and counsel to defend Claims asserted against policyholders who demonstrate financial hardship and an inability to otherwise provide for a defense.

The partial discontinuance of payment of Loss Adjustment Expenses as provided herein shall not affect or reduce the obligations and liability to Mutual Fire and the Rehabilitator of Reinsurers under contracts, agreements and treaties providing for reinsurance of obligations of Mutual Fire.

Nothing contained herein is intended to or shall relieve any of Mutual Fire's managing general agents of their duties and obligations to Mutual Fire and to the Rehabilitator.

The Rehabilitator may continue in her discretion to employ investigators, adjustors and counsel to defend direct actions against Mutual Fire and/or the Rehabilitator.

Policyholders may include in their Claims against Mutual Fire, for further review and consideration by the Rehabilitator, all costs incurred in defending insured Claims, which costs [33] would have been paid by Mutual Fire except for the suspension of certain Loss Adjustment Expenses herein. The Rehabilitator and Mutual Fire shall not be bound by adjustments and settlements entered into by Policyholders unless approved by the Court.

[34] SECTION X.
DISPUTE RESOLUTION

A. Any party to a dispute (other than disputed Claims which shall be resolved pursuant to Section VII of this Plan) in which the rights of all necessary parties are within the scope of an arbitration clause by which all such parties would be bound absent these Rehabilitation proceedings may petition the Court and request that the dispute be resolved by the Court rather than by arbitration. The Court shall grant such a petition in its discretion based upon a determination that resolution by the Court is in the best interest of the estate and will not unduly prejudice any party to the dispute.

B. Disputes not subject to a valid and binding arbitration clause shall be heard and determined by the Court.

C. The Court may appoint from time to time one or more special masters to hear and make a preliminary determination on factual and legal issues that are not subject to or are not suitable for arbitration under this Plan.

D. The Court shall retain jurisdiction to establish schedules for arbitrations, to review discovery orders, to appoint arbitrators where the parties fail to do so, to

approve Mutual Fire's appointment of qualified arbitrators and selection of umpires, to determine significant questions of law to avoid unnecessary litigation, and otherwise to review arbitrations [35] where the law of the Commonwealth of Pennsylvania or other applicable law permits or requires.

E. Arbitration panels and special masters may apply to the Court for enforcement of such procedural, discovery, and other orders of such panels and masters as may be necessary or appropriate for the expeditious and fair resolution of disputes.

[36]

SECTION XI.
ADMINISTRATIVE EXPENSE PROCEDURES

The Rehabilitator shall have full power to direct and manage, to hire, compensate and discharge employees subject to any contract rights they may have, and to deal with the property and business of Mutual Fire.

A. No administrative expenses other than ordinary and necessary expenses, or under contracts separately approved by the Rehabilitator, may be paid until approved by the Court.

B. Professionals approved by the Court to perform services for Mutual Fire or the Rehabilitator shall submit fee applications to the Court for approval in a form adequate for the Court to determine whether professional fees and expenses are necessary, reasonable, and prudent.

C. Loss Adjustment Expenses incurred in connection with the adjustment, investigation and defense of Claims asserted directly against Mutual Fire, including the costs of counsel, claims adjusters, and

others providing services to or on behalf of Mutual Fire shall be submitted at least quarterly for approval of the Court.

D. Defense attorneys (except for closed cases) and other vendors of services qualifying as Loss Adjustment Expenses shall submit a monthly summary of all such expenses incurred on behalf of Mutual Fire from June 13, 1986, to the date of the loss adjustment expense application, indicating:

[37] 1. the specific matter or matters to which the work and out of pocket expenses relate;

2. hourly rates or other basis for determining professional fees, which shall be subject to approval by the Court unless set forth in a prior contract with the Rehabilitator;

3. the amounts of such fees and expenses for which payment has been received from Mutual Fire and the basis for determining such charges; and

4. the amounts of such fees and expenses that have not been paid and the basis for determining such charges.

[38] SECTION XII.
PAYMENT OF PREMIUMS TO MUTUAL FIRE

A. An agent, broker, premium finance company, Cedent, Reinsurer or any other person, including Policyholders, responsible for the payment of a premium or returned premium shall be obligated to pay any unpaid premiums, whether earned or unearned. No credit or setoff shall be allowed in favor of such person against his account with Mutual Fire, for the unearned portion of the premium on any cancelled policy, unless (i) that

policy was cancelled prior to the entry of the Suspension Order of September 12, 1986, and (ii) the unearned premium on the cancelled policy was in fact refunded or credited to the insured or his assigns prior to the entry of said Order. The Rehabilitator shall also have the right to recover from such person any part of an unearned premium that represents a commission to such person.

B. Policyholders shall be obligated to pay any unpaid earned premium due at any time to Mutual Fire.

[39] SECTION XIII.
INJUNCTION; NON-INTERFERENCE; AND DEALING WITH MUTUAL FIRE POST CONFIRMATION

A. All Reinsurers and managing or underwriting agents, and all agents, officers, attorneys, directors and employees thereof and all persons in active concert or participation therewith are enjoined from commencing or continuing any action or proceeding (whether legal, equitable, administrative, or judicial in nature) to determine or adjudicate any right or obligation of Mutual Fire, except in the Court or in accordance with a procedure approved by the Court.

B. No action at law or equity shall be brought against Mutual Fire or the Rehabilitator, or any employee, agent or representative of the Rehabilitator, whether in the Commonwealth of Pennsylvania or elsewhere, nor shall any such existing actions be maintained or further prosecuted, nor shall any counterclaim or setoff be asserted in any action brought by or on behalf of the Rehabilitator, whether in Pennsylvania or elsewhere, except as permitted under the terms of this Plan or by the Court. The Rehabilitator and her Special Deputies shall be immune from suit while acting in their official capacities.

C. The officers, directors, trustees, Policyholders, agents and employees of Mutual Fire, and all other persons, are permanently enjoined and restrained from making or executing any levy upon the property or estate of Mutual Fire, or from [40] in any way interfering with the Rehabilitator in her possession, control or management of Mutual Fire, or in the discharge of her duties, or in the rehabilitation of the business of Mutual Fire.

D. The officers, directors, trustees, Policyholders, agents and employees of Mutual Fire, and all other persons, having any property or records belonging to Mutual Fire, including data processing information, systems and records of any kind such as, by way of example only, source documents, are hereby directed to assign, transfer and deliver to the Rehabilitator all of such property in whatsoever name the same may be, and any persons, firms or corporations having any books, papers or records relating to the business of Mutual Fire shall preserve the same and submit these to the Rehabilitator for examination at all reasonable times.

E. All persons, firms, governmental and business entities and corporations are hereby permanently restrained and enjoined from instituting, prosecuting or pursuing, or attempting to institute, prosecute or pursue, any suits or proceedings, at law or in equity or otherwise, against Mutual Fire or its successors or assigns or against any of the assets or property of Mutual Fire or its successors or assigns, directly or indirectly, on account of or based upon any right, claim or interest of any kind or nature whatsoever which any such person, firm, governmental or business entity or corporation may have in, to or against Mutual Fire, or

any of its assets [41] or properties, and from interfering with, attaching, garnishing, levying upon, enforcing liens against or upon, or in any manner whatsoever disturbing, any portion of the property, real, personal or mixed of any kind or character, on or at any time after the date of the Order approving and confirming this Plan in the possession of Mutual Fire, and from interfering with, or taking steps to interfere with Mutual Fire, its officers and agents, or the operation of the properties or the conduct of the business of Mutual Fire, by reason or on account of any obligation or obligations incurred by Mutual Fire, except the obligations imposed upon Mutual Fire by the Plan or by the Order approving and confirming the Plan. All persons, firms, governmental and business entities and corporations are hereby restrained and enjoined from instituting, prosecuting or pursuing or attempting to institute, prosecute or pursue any suit or proceeding, at law or in equity or otherwise, against Mutual Fire or any of its assets or property, directly or indirectly, except such suits or proceedings as may be for the purpose of carrying out this Plan or the Order approving and confirming this Plan.

[42]

SECTION XIV.
CORPORATE RESTRUCTURE

The Rehabilitator will evaluate the potential for corporate restructuring of Mutual Fire in order to provide additional assets. Upon completion of the Rehabilitator's evaluation, the Rehabilitator will notify interested parties and file with the Court recommendations regarding the alternatives available that would leave Mutual Fire with the capital and surplus required by Pennsylvania law. The Rehabilitator will evaluate the potential for consolidation, conversion

to stock form, or merger of Mutual Fire and shall submit her report to the Court. Mutual Fire shall maintain on deposit with the Commonwealth of Pennsylvania the minimum capital and surplus required under Pennsylvania Law.

Any discharge of indebtedness pursuant to this Plan shall be treated as an adjustment to surplus.

[43] SECTION XV.
MISCELLANEOUS PROVISIONS
CONCERNING REINSURANCE

A. Nothing contained in this Plan shall release or diminish any claim that Mutual Fire or the Rehabilitator may have against Reinsurers or Retrocessionaires for the full amount of Reinsurance applicable to any Claim, whether or not Mutual Fire has paid the Claim in whole or in part.

B. Nothing contained in this Plan shall release or diminish the obligation of a Reinsurer or Retrocessionaire of Mutual Fire to pay the full amount of Reinsurance applicable to any Claim.

C. Reinsurance obligations to Mutual Fire shall become due and owing immediately upon reporting by Mutual Fire of adjustment of Loss Claims and Mutual Fire shall have no obligation to pay any Loss Claims as a condition precedent to collection of Reinsurance.

D. A Reinsurer or Retrocessionaire that makes a payment to Mutual Fire during the period of Rehabilitation proceedings shall not be required to pay such sums again in the event of subsequent liquidation proceedings.

E. Interest shall be charged on Reinsurance balances due for paid or adjusted Losses beginning ninety (90) days after the balance due was billed to the Reinsurer for all amounts ultimately found due and owing Mutual Fire by a Reinsurer. [44] The interest rate that shall be charged for balances due shall be six percent (6%) per annum, compounded daily.

F. Direct actions by Creditors or their assigns against Mutual Fire's Reinsurers are prohibited.

[45] SECTION XVI.
MISCELLANEOUS PROVISIONS (GENERAL)

A. No Acceleration Permitted

No Claimant holding security of Mutual Fire may accelerate Mutual Fire's obligations to it without a separate order of the Court.

B. Financial Reports

Mutual Fire shall file quarterly financial reports with the Court showing Mutual Fire's current financial condition, a balance sheet, an income statement, a cash flow statement, operating and administrative expenses, status of reinsurance and other asset collections, and such supporting schedules as are necessary to present Mutual Fire's financial condition fairly.

C. Settlements

No compromise or settlement of Mutual Fire's rights or any disposition of its assets shall be effective without the prior approval of the Court or prior approval of guidelines and limitations.

D. Hardship Claims

Notwithstanding anything to the contrary contained in this Plan, upon petition of the Rehabilitator, the Court may on a case by case basis consider and pay hardship Claims and Loss Adjustment Expenses of Policyholders.

[46] E. Policy Limits

No Adjusted Claim under a policy of insurance shall be allowed for an amount in excess of the applicable policy limits. If several Adjusted Claims founded upon one policy are made, and the aggregate allowed amount of the Adjusted Claims to which the same limit of liability in the policy is applicable exceeds that limit, each Adjusted Claim as allowed shall be reduced in the same proportion so that the total equals the policy limit.

F. Subsequent Liquidation

Distributions and other payments made to Claimants under this Plan shall not be set aside or contested by a Liquidator in the event of liquidation of Mutual Fire.

G. Full Powers of the Rehabilitator

The Rehabilitator and, as delegated by the Rehabilitator, her Special Deputies, shall have the full powers delegated under Article 5 of the Insurance Department Act of 1921, as amended, any additional powers delegated by Order or ruling of Court, (including but not limited to Order of Court dated December 8, 1986), and any other powers granted by other provisions of the law. The powers thus conferred upon the Rehabilitator and her Deputies include, but are not limited to, the right to take legal action against Reinsurers, officers and directors, managers, general

agents, employees, or any [47] other persons, where recovery in such an action will inure to the benefit of Policyholders, Cedents and other Creditors.

H. Reservation of Rights

The descriptions of the rights, title and interests of Mutual Fire, Policyholders, Creditors and other parties in interest whose Claims are treated herein are not admissions as to the rights, title and interests of any such entity but merely an indication of what rights and status shall be granted to such entity if the Plan is confirmed in substantially this form, and implemented.

I. Dissolution of Committee of Policyholders

Upon the date of an Order of the Court approving and confirming this Plan the Official Committee of Policyholders shall be dissolved and professional persons employed by said Committee shall not be compensated from the assets of the estate of Mutual Fire thereafter.

J. Continuance of Coverage

All policies of insurance written by Mutual Fire in effect at the time of issuance of an Order of the Court approving and confirming this Plan shall continue in force only with respect to the risks in effect, at that time (i) for a period of thirty (30) days from the date of said Order; (ii) until the normal expiration of policy coverage; or (iii) until the insured has replaced the insurance coverage with equivalent insurance in another insurer or otherwise termintated the policy, whichever time is less.

[48] K. Preservation of Remedies

Payment of an Adjusted Claim shall not preclude the Rehabilitator from subsequently pursuing any remedies at law or in equity against a Policyholder or Claimant.

[49] SECTION XVII.
INTEREST

Except as may be otherwise provided for in this Plan, or as may be otherwise required under applicable law, all Creditors holding Unsecured Claims shall waive interest, late charges, penalties, attorneys' fees and court costs against Mutual Fire and the Rehabilitator except for attorneys' fees and costs approved for reimbursement by Order of the Court prior to the Effective Date and all Creditors shall waive all claims against any disbursing agent and any entity disbursing funds for interest, including interest on funds to be distributed under the Plan, late charges, penalties, attorneys fees, court costs and any other charges of any kind for which payment is not expressly provided for in this Plan.

[50]

SECTION XVIII.
DISCHARGE

Mutual Fire, as of the date of the Order approving and confirming this Plan, shall be discharged and released from all of its obligations, debts, liabilities and claims, whether or not filed or presented, whether or not approved, acknowledged or allowed by Mutual Fire, (or in these proceedings), or whether or not provable in bankruptcy or otherwise, except for the obligations imposed upon Mutual Fire by the Plan or by the Court.

Dated: January 30, 1989

Respectfully submitted,

/s/ CONSTANCE B. FOSTER
Costance B. Foster
Insurance Commissioner of the Commonwealth of Pennsylvania, as Rehabilitator of The Mutual Fire, Marine & Inland Insurance Company

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CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

U.S. Const., art. I, §8, cl. 3.

The Congress shall have Power . . . To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes. . . .

U.S. Const., art. I, §10, cl. 1.

No State shall enter into any Treaty, Alliance, or Confederation; grant Letters of Marque and Reprisal; coin Money; emit Bills of Credit; make any Thing but gold and silver Coin a Tender in Payment of Debts; pass any Bill of Attainder, ex post facto Law, or Law impairing the Obligation of Contracts, or grant any Title of Nobility.

U.S. Const., art. VI, cl. 2.

This Constitution and the Laws of the United States which shall be made in Pursuance thereof, and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

U.S. Const., amend. XIV, §1.

All persons born or naturalized in the United States and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of the law; nor deny to any person within its jurisdiction the equal protection of the laws.

Federal Arbitration Act, 9 U.S.C. §2.

A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction, or the refusal to perform the whole or any part thereof, or an agreement in writing to submit to arbitration an existing controversy arising out of such a contract, transaction, or refusal, shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.

McCarran-Ferguson Act
15 U.S.C. §1012(b)

No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

31 U.S.C. §3713(a).

(1) A claim of the United States Government shall be paid first when—

(A) a person indebted to the Government is insolvent and—

(i) the debtor without enough property to pay all debts makes a voluntary assignment of property;

(ii) property of the debtor, if absent, is attached; or

(iii) an act of bankruptcy is committed; or

(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

(2) This subsection does not apply to a case under title 11.

40 P.S. §221.15(a)

The commissioner may apply by petition to the Commonwealth Court, for an order authorizing him to rehabilitate a domestic insurer or an alien insurer domiciled in this Commonweatlh, alleging that the insurer has committed one or more acts which may constitute grounds for rehabilitation as set forth in section 514 of this article.

40 P.S. §221.32(a)

Mutual debts or mutual credits between the insurer and another person in connection with any action or proceedings under this article shall be setoff and the balance only shall be allowed or paid, except as provided in subsection (b).

Supreme Court, U.S.
FILED
DEC 21 1992
CLERK

No. 92-873

In The

Supreme Court of the United States

October Term, 1992

ALLSTATE INSURANCE COMPANY,

Petitioner,

v.

CYNTHIA M. MALESKI, Acting Insurance Commissioner of the Commonwealth of Pennsylvania, as Rehabilitator of the Mutual Fire, Marine and Inland Insurance Company,

Respondent.

Petition For Writ Of Certiorari To The Supreme Court Of Pennsylvania

BRIEF IN OPPOSITION

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31 pp

COUNTERSTATEMENT OF THE QUESTIONS PRESENTED

(1) Where Petitioner concedes that it did not argue, in the state court proceedings, that either the Pennsylvania Insurance Department Act or the Plan of Rehabilitation violates the Federal Arbitration Act, and where one of the issues in the Petition is that the Pennsylvania Insurance Department Act is in conflict with the Federal Arbitration Act, should that issue be addressed?

(2) Where the specific contract provisions relied upon by Petitioner for its Contract Clause claim were not entered into the record below, should this Court consider Petitioner's claim that the Plan impairs those contract provisions in violation of Article I, Section 10 of the United States Constitution?

(3) Where the sole issue presented is whether or not the Plan of Rehabilitation grants more restrictive rights of setoff than Petitioner would receive in a liquidation and where the Pennsylvania Supreme Court has held, based upon its interpretation of the Pennsylvania Insurance Department Act, that, with respect to setoff, the rights of creditors set forth in the Plan of Rehabilitation are the same as they would be in liquidation, should the Petition for Writ of Certiorari be denied?

(4) Where the Pennsylvania Supreme Court, in interpreting the Pennsylvania Insurance Department Act, has held that the substantive law of the Commonwealth of Pennsylvania (in the context of insurance insolvency proceedings) grants creditors the same setoff rights in rehabilitation as it does in liquidation, and where the sole issue raised in the Petition is that Petitioner will not

COUNTERSTATEMENT OF THE QUESTIONS PRESENTED – Continued

receive the same rights in rehabilitation as it would in liquidation, should this Court address issues involving the state court's interpretation of substantive state law?

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COUNTERSTATEMENT OF THE CASE

Respondent is Cynthia M. Maleski, the Acting Insurance Commissioner of the Commonwealth of Pennsylvania, as Statutory Rehabilitator ("Rehabilitator") of The Mutual Fire, Marine and Inland Insurance Company ("Mutual Fire"). On December 8, 1986, the Commonwealth Court of Pennsylvania entered an Order placing Mutual Fire into rehabilitation pursuant to the Pennsylvania Insurance Department Act (the "Act"), 40 P.S. § 221.15(a), and appointing the Insurance Commissioner of the Commonwealth of Pennsylvania as Rehabilitator pursuant to 40 P.S. § 221.15(c).[1]

Mutual Fire is a mutual insurance company which was incorporated in 1902 under the laws of the Commonwealth of Pennsylvania.[2] Before it ceased writing business in 1986, Mutual Fire's business included a broad range of property, casualty and special risks insurance, with substantial reliance upon reinsurance. Mutual Fire is licensed to do business in Pennsylvania, Delaware, New York and Puerto Rico, and operates on a surplus lines (non-admitted) basis in virtually every other state.

Article V of the Act governs the rehabilitation and liquidation of insolvent insurance companies in Pennsylvania. Its stated purpose is "the protection of the interests

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[1] Under the Pennsylvania Insurance Department Act, the Commonwealth Court is assigned jurisdiction over, and supervisory responsibility for, insurance rehabilitations and liquidations. 40 P.S. § 221.4.

[2] Mutual Fire has no parent company. Mutual Fire's subsidiaries, as defined by Sup. Ct. R. 29.1, are: Endmark Data Processing Corporation; Ryansure Intermediaries, Inc.; Cable Life Insurance Co.; UMI Asset Management and UMI Holdings.

of insureds, creditors, and the public generally" through, *inter alia*, "equitable apportionment of any unavoidable loss." 40 P.S. § 221.1(c). The Act affords the Insurance Commissioner, as statutory rehabilitator, broad discretion and authority to "take such action as [s]he deems necessary or expedient to correct the condition or conditions which constituted the grounds for the order of the court to rehabilitate the insurer." *Foster v. Mutual Fire, Marine & Inland Insurance Company*, 1992 W.L., 210948 (Pa. August 21, 1992) (A7),[3] citing 40 P.S. § 221.16(b). This includes the discretion and authority to formulate a plan for rehabilitating an insolvent insurance company. 40 P.S. § 221.16(d).

On January 31, 1989, pursuant to 40 P.S. § 221.16(d), the Rehabilitator submitted to the Commonwealth Court a Plan of Rehabilitation for Mutual Fire (the "Plan"). Various creditors, including Petitioner, filed objections to the Plan. On July 25, 26, 28, and August 1, 1989, hearings were held before the Honorable James Crumlish, Jr., then President Judge of the Commonwealth Court, to consider the proposed Plan.

A. SECTION II OF THE PLAN PROTECTS SECURED CREDITORS' RIGHTS

The Plan establishes separate classes of creditors based upon the priority of distribution set forth in 40 P.S. § 221.44. Pertinent classes include:

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[3] References to the Appendix in the Petition of Allstate are designated as "A ___."

Class 1 – Secured Cedents;

Class 2 – Administrative Claims;

Class 3 – Wage Claims;

Class 4 – Policyholder Claims (which excludes surety bond lenders, cedents and reinsurers);

Class 5 – Surety Bond lenders;

Class 6 – General Unsecured Creditor Claims (including those of cedents and reinsurers).

Petitioner Allstate both reinsured, and ceded business to, Mutual Fire.[4] To the extent that Allstate is a secured cedent (*i.e.*, Mutual Fire was required to pledge collateral to secure its obligations), it qualifies as a Class 1 creditor under the Plan.

Section II(A) of the Plan adequately protects secured cedents' rights by providing that they can draw upon their collateral (whether in the form of letters of credit or trusts) for the full amount of their approved claims. (A91-92.) Until such claims are adjusted under the Plan, Petitioner Allstate and the other secured cedents necessarily retain their liens against the collateral which they hold.

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[4] Cedents are companies whom Mutual Fire reinsures. Reinsurers are companies obligated to Mutual Fire under contracts of reinsurance, having assumed Mutual Fire business. Mutual Fire Plan, § I(4), (26) (A87, A90).

B. SECTION III OF THE PLAN PROTECTS SET-OFF RIGHTS

The Plan directs the Rehabilitator to marshal estate assets, in particular, reinsurance recoveries, which constitute the most significant and substantial asset of Mutual Fire. (Hearing Transcript, T. 40, 44.) Nevertheless, the Plan gives appropriate recognition to the traditional equitable remedy of setoff between cedents and reinsurers. Under Section III(D), mutual debts and credits, to the extent that such obligations were due and owing as of December 4, 1986 (the date on which the Insurance Commissioner filed her Petition for Rehabilitation), may be set off.[5] Thus, the Plan expressly permits creditors to exercise their right to set off matured, liquidated obligations as of the date of the filing of the Rehabilitation Petition. Case reserves as of December 4, 1986 (which are estimates of the amounts required to cover future payments on account of known claims) and IBNR as of that date (amounts predicted to be paid in the future on account of events that have occurred but have not been reported as claims) are not mutual debts under Pennsylvania law and thus, are not available for setoff.

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[5] The term "due and owing" refers to reinsurance amounts recoverable on paid Losses (*i.e.*, payments by cedents to policyholders and other claimants), paid Loss Adjustment Expenses, Claim settlements and reimbursement agreements. Mutual Fire Plan, § I(11) (A88).

While the Plan allows setoff of mutual debts and credits as stated above, Section III(B) precludes setoff of any premium obligations due to Mutual Fire. (A98.) This provision is based upon 40 P.S. § 221.32(b)(4), which expressly prohibits setoff of premium obligations:

> (b) No setoff or counterclaim shall be allowed in favor of any person where:
>
> (4) The obligation of the person is to pay premiums, whether earned or unearned, to the insurer.

40 P.S. § 221.32(b)(4). Section 221.32 applies both to rehabilitations and liquidations. (A19.)

C. SECTION X OF THE PLAN PROTECTS ARBITRATION RIGHTS

In addition, the Plan (Section X) grants discretion to the Commonwealth Court to allow court resolution of claims otherwise subject to contractual arbitration clauses on a case-by-case basis. Contrary to Allstate's assertion that "the party seeking arbitration" is required to obtain Court approval (Petition, p. 5), Section X clearly states that *the party seeking court resolution in lieu of arbitration is required to petition the Court*. (A112.) Moreover, in order to forego arbitration, the Court must make a determination that court resolution "is in the best interest of the estate and will not unduly prejudice any party to the dispute." (Plan, § X, A112.)

D. FINDINGS BY THE COMMONWEALTH COURT AND THE SUPREME COURT OF PENNSYLVANIA

In an Opinion and Order dated January 23, 1990, the Pennsylvania Commonwealth Court (per then President Judge Crumlish) approved, with certain modifications, the Plan submitted by the Rehabilitator and concluded as follows:

> Having considered all objections and found that the proposed Plan, with modifications, constitutes an equitable apportionment of unavoidable loss, is in the best interests of insureds and other creditors, and does not constitute an abuse of the Rehabilitator's discretion, we modify the Plan consistent with this Opinion and approve it in all other respects.

Grode v. Mutual Fire, Marine & Inland Insurance Company, 132 Pa. Commw. 196, 572 A.2d 798 (1990) (A71).

In particular, the Commonwealth Court expressly found that the alleged contractual impairments challenged by Petitioner and other creditors (including rights asserted with respect to collateral, setoff and arbitration) "are, for the most part, insubstantial and do not warrant modification of the Plan except as hereinafter provided." (A52.) The Commonwealth Court then modified Section III(D) and imposed the following additional requirements with respect to setoff:

> (i) the Rehabilitator is to notify creditors of her setoff calculations within 90 days of approval of the Plan;
>
> (ii) creditors have 30 days to object to the setoff calculation; and

> (iii) any dispute over the setoff calculation is to be resolved pursuant to the claim resolution procedures of Section VII of the Plan. (A73.)

The Court also rejected the objections to Section X, and concluded that it simply allows parties to *request* court resolution in lieu of arbitration. (A66.)

Petitioner appealed this decision to the Pennsylvania Supreme Court, arguing that Sections II, III and X of the Plan impermissibly impaired its contractual rights. Petitioner concedes that it did not argue, either in the Commonwealth Court or in the Pennsylvania Supreme Court, that Section X violated the Federal Arbitration Act. (Allstate Petition, pp. 6-7.)

The Pennsylvania Supreme Court rejected the arguments raised by Allstate and the other creditors on appeal. With respect to the questions Petitioner presents for review by this Court, the Pennsylvania Supreme Court made the following specific findings:

> (1) Section III of the Plan "ensures that the creditors herein, at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding," in accordance with *Neblett v. Carpenter*, 305 U.S. 297 (1938). (A19.)
>
> (2) 40 P.S. § 221.32, which establishes what forms of setoff will be permitted, encompasses both liquidation and rehabilitation in Pennsylvania. (A19.)
>
> (3) "Mutual debts and credits" under 40 P.S. § 221.32 are limited to debts which are due and owing (*i.e.*, liquidated, matured) as of December 4, 1986, the date upon which the petition for rehabilitation was filed. (*Foster*, citing

Commonwealth ex rel. Bell v. Tradesmen's Trust Company, 250 Pa. 372, 95 A. 574 (1915).) (A22.)

(4) The "speculative and intangible nature" of case reserves and IBNR at the time of the filing of the petition for rehabilitation "does not warrant their being available for setoff." (A22-23.)

(5) Under Pennsylvania law, setoff is an equitable remedy and accordingly, "is permissive, not mandatory." (A22.)

(6) Allowing reinsurers/cedents to set off obligations that had not matured as of the filing of the rehabilitation petition would result in a windfall. (A23.)

(7) Section III of the Plan satisfied the three-part test set forth by this Court in *Energy Reserves Group, Inc. v. Kansas Power and Light*, 459 U.S. 400 (1983). (A16.)

(8) The Commonwealth Court's approval of Section X(A) was correct. (A36.)

The Pennsylvania Supreme Court also rejected Petitioner Allstate's argument that the Mutual Fire Plan was a *de facto* liquidation which would wind up the company's affairs. (A13-14.) The Supreme Court fully agreed with the Commonwealth Court's conclusion that:

> . . . the ultimate goal of the Plan *is* to have Mutual Fire reemerge as a solvent insurer. The Plan calls for Mutual Fire's possible restructure and orders that it maintain its required capital and surplus minimums required in order to resume operations in the future.

(A14.) Thus, Petitioner is misleading this Court with its repeated characterizations of Mutual Fire as a "defunct"

insurance company and its descriptions of the insolvency proceeding as a liquidation, rather than a rehabilitation.

REASONS FOR REFUSAL OF THE WRIT

Petitioner's argument that the Plan abrogates its alleged contractual arbitration rights in violation of the Federal Arbitration Act was never raised in the state court proceedings. Having waived any constitutional argument on this issue, Petitioner is simply attempting to generate a federal question in a case where none exists.

Petitioner's remaining argument in support of review is premised upon seriously flawed, and unsupported, assumptions. First, Petitioner argues that it would have been entitled to offset "significantly more" of its obligations in a liquidation proceeding. (Petition, p. 24.) This contention is based, not upon any case or statute, but upon Petitioner's "belief" that mutual claims, for purposes of setoff in liquidation proceedings, include case reserves and IBNR. (Petition, p. 9, n.5.) This "belief" is mistaken and as will be discussed, ignores completely the Pennsylvania Supreme Court's interpretation of 40 P.S. § 221.32, the statutory provision governing setoff, and settled Pennsylvania law.[6]

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[6] 40 P.S. § 221.32 provides, in pertinent part, that "mutual debts or mutual credits . . . shall be set off and the balance only shall be allowed or paid, except as provided in subsection (b)." Subsection (b) expressly prohibits setoff where, *inter alia*, (1) the obligation of the insurer to the person seeking setoff would not, at the date of the filing of a petition for liquidation, entitle that party to share as a claimant in the insurer's assets and (4) the

Petitioner's assertions that the Pennsylvania Supreme Court "refus[ed] to apply" this Court's decision in *Neblett v. Carpenter*, 305 U.S. 297 (1938), *reh'g denied*, 305 U.S. 675 (1939), simply make no sense. (Allstate Petition, p. 24). The Pennsylvania Supreme Court's determination that the Mutual Fire Plan satisfied the requirements of *Neblett* could not have been more explicit:

> Under *Neblett*, creditors must fare at least as well under a rehabilitation plan as they would under a liquidation, which [Petitioners] currently argue, would not be the case under this Plan. We disagree. . . . (A14.)

The Court also found that Section III of the Plan complied with the Act's relevant provision regarding setoff (40 P.S. § 221.32), which applies to rehabilitations as well as liquidations. (A19.)[7] Thus, the Court found that, under the Plan's setoff provisions, creditors "at a minimum, will fare at least as well under the rehabilitation as they would in a liquidation proceeding, as mandated by the holding of *Neblett, supra.*" (A19.)

Petitioner seeks review of the Pennsylvania Supreme Court's decision approving the Mutual Fire Plan of Rehabilitation because it is dissatisfied with that Court's findings and conclusions with respect to matters of substantive Pennsylvania law. Petitioner would have this

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obligation is to pay premiums, whether earned or unearned, to the insurer.

[7] In fact, the Plan, as modified by the Commonwealth Court, specifically incorporates 40 P.S. § 221.32, removing any doubt that setoff under the Plan is identical to setoff under the Act.

Court substitute its judgment for that of the Pennsylvania Supreme Court in matters involving the interpretation of (1) the Pennsylvania Insurance Department Act and its provisions regulating insolvent insurance companies; and (2) Pennsylvania common law governing "mutual" debts and credits. This Court, which does not sit in appellate review of state court judgments, has consistently refused to exercise its jurisdiction over such matters of substantive state law. *Ridgway v. Ridgway*, 454 U.S. 46, 54 (1981); *Hortonville Dist. v. Hortonville Ed. Assoc.*, 426 U.S. 482, 488 (1976).

With respect to its claim under Article I, Section 10 of the United States Constitution (the "Contract Clause"), Petitioner is asking this Court to assess the Plan's impact upon specific contract provisions (relating to collateral, setoff and arbitration) which are not before the Court and were never made part of the record in the state court proceedings. In any event, the Pennsylvania Supreme Court specifically found that (i) the Plan did not constitute a substantial impairment of Petitioner's contractual rights; and (ii) the Plan (including its provisions relating to secured creditors, setoff and arbitration) served a legitimate and significant public purpose, and was "legitimately designed to ameliorate a financial hazard for the good of all involved." (A17.)

A. PETITIONER HAS WAIVED ANY CONSTITUTIONAL CHALLENGE TO SECTION X OF THE PLAN

In presenting its questions for review, Petitioner contends that Section X of the Plan, which grants the

Commonwealth Court of Pennsylvania the discretion to allow court resolution in lieu of arbitration on a case-by-case basis, abrogates its rights to arbitrate under reinsurance contracts with Mutual Fire, and therefore, violates the Federal Arbitration Act, 9 U.S.C. § 1 *et seq.* However, Petitioner eventually concedes that "[its] brief and oral statement in the Commonwealth Court did not specifically mention the Federal Arbitration Act and its conflict with the McCarran-Ferguson Act. . . . " (Allstate Petition, pp. 6-7.) Likewise, Petitioner admits that it failed to raise this issue before the Pennsylvania Supreme Court:

> Petitioner's brief to the Supreme Court of Pennsylvania restated its objection to the Plan's abrogation of its contractual right to arbitration, *but did not specifically reference the Federal Arbitration Act.* (emphasis added.)

(Allstate Petition, p. 7.)

Obviously, Petitioner Allstate is attempting to fashion a federal question for review by this Court where none exists. As a result of Petitioner's failure to raise these issues, the Pennsylvania courts had no opportunity to pass on the applicability of the Federal Arbitration Act to the provisions of the Plan. *Bankers Life & Casualty Co. v. Crenshaw*, 486 U.S. 71, 76 (1988). Petitioner has clearly waived the argument which it seeks to present concerning a "conflict" between the Federal Arbitration Act and the McCarran-Ferguson Act. (Allstate Petition, pp. 13-22.) As this Court has stated:

> . . . at the minimum . . . there should be no doubt from the record that a claim under a

> *federal* statute or the *Federal* Constitution was presented in the state courts. . . .

Bankers Life, 486 U.S. at 77-78.

In any event, the Plan does *not* abrogate arbitration rights of Petitioner and other creditors, but simply grants the Commonwealth Court the discretion to allow court resolution in lieu of arbitration on a case-by-case basis. Under Section X of the Plan, arbitration will be supplanted only where court resolution is: (1) requested by at least one party; and (2) granted by the court upon a finding that it is in the best interest of the estate, without undue prejudice to any party. (A112.) In approving Section X(A) of the Plan, the Commonwealth Court explicitly stated: "We construe this section as permitting parties to a dispute to *request* Commonwealth Court resolution in lieu of arbitration." (A66.) The Pennsylvania Supreme Court agreed. (A36.)

Moreover, even if Petitioner had properly raised and preserved a challenge to Section X, the issues presented in the Petition are not ripe for review. There has been no suggestion by Petitioner that the Commonwealth Court abused its discretion by denying arbitration in any case, nor has any factual record been developed which could be presented to this Court for review.[8] On the contrary, acknowledging that there is no case or controversy with regard to Section X, Petitioner simply suggests that this issue "needs further refinement" (Petition, p. 12) and in

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[8] In fact, the Rehabilitator filed petitions under Section X seeking court resolution to resolve contract disputes with several reinsurers. These petitions were *denied* by the Commonwealth Court.

effect, is seeking an advisory opinion. Above all, it is properly within the discretion of the Commonwealth Court and within the realm of its jurisdiction, to decide whether court resolution is preferable in any specific instance based upon the best interest of the estate.

B. THE PENNSYLVANIA SUPREME COURT'S DECISION APPROVING THE PLAN DEALS EXCLUSIVELY WITH MATTERS OF SUBSTANTIVE PENNSYLVANIA LAW

The Pennsylvania Supreme Court specifically found that case reserves and IBNR, which are unliquidated and contingent as of the date of the filing of a petition for rehabilitation or liquidation, are not "mutual" *under Pennsylvania law* and hence, not subject to setoff. (A22-23.)[9] That Court also found that any actual contractual impairments arising out of the Plan (including the alleged effects upon security interests, setoff and arbitration claims) were "insubstantial" and, in any event, such Plan provisions were "legitimately designed to ameliorate a financial hazard for the good of all involved." (A15-17.)

Petitioner is simply challenging the Pennsylvania Supreme Court's interpretation of Pennsylvania law with

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[9] By letter dated December 17, 1992, counsel was advised that Allstate intends to file a supplemental brief presenting the case of *Prudential Reinsurance Company v. Superior Court of Los Angeles County*, 1992 W.L. 347585 (Cal. Supreme Court, Nov. 30, 1992). As of this printing, no supplemental brief has been received. If such a brief is filed in this case, Respondent reserves the right to file a supplemental brief in response thereto.

regard to the purpose of the Insurance Department Act and the meaning of "mutuality." This type of challenge is not, and never has been, a basis for seeking review by this Court. In fact, this Court considers itself "bound to accept the interpretation of [state] law given by the highest court of the state," *Hortonville Dist.*, 426 U.S. at 488, and has emphasized that decisions of state courts will be subject to disturbance only to the extent that "they incorrectly adjudge *federal* rights." *Ridgway*, 454 U.S. at 54 (emphasis added).

C. THE PENNSYLVANIA SUPREME COURT EXPRESSLY FOUND THAT THE PLAN SATISFIES THE REQUIREMENTS OF *NEBLETT*

1. "MUTUAL" DEBTS/CREDITS FOR PURPOSES OF SETOFF DO NOT INCLUDE CASE RESERVES AND IBNR

As stated, in considering *Neblett*, the Pennsylvania Supreme Court removed any need to compare setoff rights under liquidation and rehabilitation when it ruled that 40 P.S. § 221.32, which is set forth under the Act's liquidation section, also applies to rehabilitations. (A18-19.)[10] Thus, regardless of whether Mutual Fire is in rehabilitation or liquidation, Petitioner would only be permitted to set off "mutual" debts and credits as provided under 40 P.S. § 221.32.

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[10] The Pennsylvania Supreme Court stressed that § 221.32 begins by stating that its provisions apply to any action or proceeding "under this article." (A19.) The term "article" refers to Article V of the Act, which encompasses both rehabilitations and liquidations. *Id.*

Notwithstanding Petitioner-Allstate's belief that Section 221.32 would permit setoff of case reserves and IBNR (Petition, p. 9, n.5), the Pennsylvania Supreme Court specifically found that a "mutual" debt must be a present, mature obligation as of the date of the filing of the petition for rehabilitation. According to the Court:

> [N]o right of setoff can be available against a note or other obligation that does not mature until after a receiver for the insolvent debtor is appointed. *Commonwealth ex rel. Bell v. Tradesmen's Trust Company,* 250 Pa. 372, 95 A. 574 (1915). *Accord, Appeal of Commonwealth Trust Co. of Pittsburgh,* 324 Pa. 161, 188 A. 200 (1936).

(A22.) The Pennsylvania Supreme Court further concluded that case reserves and IBNR "are not present obligations of the reinsurer":

> Case reserves and IBNR are at most calculations or estimates of future, potential liabilities, which often times are contingent upon a later development or growth of the claim or some intervening procedure such as litigation.

(A22.) According to the Court, the unliquidated nature of case reserves and IBNR at the time of the filing of the petition for rehabilitation "does not warrant their being available for setoff. . . . " *Id.*[11] The Pennsylvania Supreme

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[11] The category of claims allowed to be set off under the Plan (the "due and owing" amounts) were matured, liquidated obligations of Mutual Fire on the date the Commissioner petitioned for rehabilitation. In the context of a reinsurance agreement, the due and owing amount represents the funds already paid by the primary insurance company, which are currently payable to the primary insurer by the reinsurance company. On

Court's interpretation of Pennsylvania law with regard to "mutuality" is not an adjudication of "federal rights" and thus, is not a subject for review by this Court. *Ridgway*, 454 U.S. at 54.

For more than a century, Pennsylvania Courts had relied upon this principle:

> Whatever may be the rights of a party whose debt is due and payable to compel an insolvent debtor to set off a claim against him not due, a party whose debt is not due has no equitable claim to have it set off against a debt of his own already due in the hands of a party who is insolvent.

Dougherty Bros. & Co. v. Central National Bank, 93 Pa. 227, 231 (1880) (citations omitted). This view is still widely accepted. *See, e.g., Liberty Sav. Ass'n v. Sun Bank of Jacksonville*, 572 F.2d 591, 595 (7th Cir. 1978) (" . . . a debt is not subject to setoff unless it has matured. . . . "); *In Re Cabrillo*, 101 Bankr. 443 (E.D. Pa. 1989) (setoff was denied in a bankruptcy proceeding with respect to an installment loan agreement, as opposed to a demand note); *see also FDIC v. Liberty Nat'l Bank & Trust Co.*, 806 F.2d 961, 969

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the other hand, case reserves are merely the primary insurance company's estimates of the amounts which it may expend in the future in defending, settling or otherwise disposing of claims which have been reported to it. Only future events (*e.g.*, a jury verdict) will determine whether additional funds will be expended on any particular claim and, if so, in what amounts. Likewise, IBNR amounts represent an estimate of expenses that *may* be incurred on account of events that have occurred but have not yet ripened into claims or been reported to the primary insurance company.

(10th Cir. 1986); and *Henz v. Superior Trucking Co.*, 96 F.R.D. 219 (M.D. Pa. 1982).

The record in this case amply supports the decision to limit setoff to liquidated due and owing amounts, not loss reserves or IBNR, as of December 4, 1986. At the hearings on the Plan, an expert on behalf of the cedents group (some of whom are Petitioners at Case No. 92-937) testified that, even in non-insolvency situations, the industry-wide practice was to use net balance accounting (*i.e.*, setoff) and that it applied *only* to due and owing balances, not case reserves or IBNR. (T. 489, 537-538.) If setoff as practiced within the insurance industry applies only to due and owing amounts, Petitioner can hardly complain that the same principle in the Plan somehow violates its contract rights.

Not only are the Plan's setoff provisions, as approved by the Pennsylvania Supreme Court, consistent with well-established Pennsylvania legal principles and the factual record, but they also implement the important public policy behind the Act of maximizing protection to policyholders (40 P.S. § 221.1(c).) Thus, the Pennsylvania Supreme Court correctly concluded that allowing Petitioner and other creditors to set off obligations against Mutual Fire that had not matured as of the time of filing the petition for rehabilitation (case reserves and IBNR) would result in a "windfall" to Petitioner not available to policyholders. (A23.)

In addition, the setoff demanded by Petitioner would wreak havoc with the Act's equitable distribution scheme under which innocent third parties (policyholders), who are dependent upon the financial obligations of these

reinsurers to Mutual Fire, have been assigned a priority above that of cedents and reinsurers. As the Pennsylvania Supreme Court observed:

> . . . [T]he exigencies attendant to a major commercial insolvency and the goals of rehabilitation necessitate the reality that "individual interests may need to be compromised in order to avoid greater harm to a broader spectrum of policyholders and the public."

(A15-16), citing *Vickodil v. Commonwealth Insurance Dept.*, 126 Pa. Commw. 390, 559 A.2d 1010, 1013 (1989).

2. THE PLAN'S TREATMENT OF SECURED CEDENTS IS AT LEAST AS FAVORABLE AS IN LIQUIDATION

Contrary to Allstate's assertions, the Plan's treatment of secured cedents' claims and collateral is perfectly clear. Section II(A) of the Plan provides that secured cedents can draw upon their collateral for *the full amount* of their approved claims. The procedure for claims adjustment and approval is clearly set forth in Section VII of the Plan. (A108.)

Should the value of the collateral exceed the amount of the secured cedents' allowed claims, that excess is to be paid to the Rehabilitator. Section II(A) (A91). The term "excess collateral" is clearly defined in the first paragraph of Section II(A) dealing with secured claims generally, to be "any collateral . . . in excess of the amount to which said Secured Creditor is entitled pursuant to this Plan. . . . " (A91.) *See also* 40 P.S. § 221.3. Should the value of the allowed claims exceed the value of the collateral,

the amount of any deficiency will be treated as a Class 6, unsecured claim. Section II(A)(l) (A91).

Until such time as the secured cedents' claims are fully adjusted pursuant to Section VII, the secured cedents necessarily retain their liens against the collateral. Nothing in the Plan abrogates the cedents' security interests.

Thus, the Plan merely provides that the payment to secured cedents from their collateral shall be made by drawing down against that collateral once their claims are finally approved. Through this orderly adjustment of claims, the Rehabilitator can determine her interest in any excess collateral.

Petitioner's argument that the Plan somehow unconstitutionally impairs its rights *vis-a-vis* its collateral is absurd. The requirements for court approval before Allstate can draw against its collateral and that Allstate be permitted to draw against its collateral those amounts due and owing from Mutual Fire, without acceleration, for paid losses and loss adjustment expenses hardly rise to the level of "impairment." (Petition, pp. 9-10.) In any event, Petitioner fails to cite any case or Insurance Act provision to support its contention that its collateral rights are "significantly less favorable" under this Plan than under liquidation. (Petition, p. 24.)

In a liquidation, the Insurance Act (40 P.S. § 221.43) requires that the secured creditors' collateral be valued by conversion into money or by agreement, compromise or litigation. Such a valuation prior to the release or payment of collateral to the secured creditor is obviously necessary to determine the estate's interest in any excess

collateral. Further, the secured creditors' claim or claims must also be determined, as provided in the liquidation sections of the Insurance Act, 40 P.S. §§ 221.38 and 221.41. Only after both the value of the collateral *and* the amount of the secured creditors' claims have been determined can the rehabilitator or liquidator know the value of the estate's interest and take appropriate steps to marshal that value for the benefit of the estate.

The process provided in the Plan for determining the secured cedents' claims and paying them from their collateral is nothing more than a method of valuing the estate's interest and providing for its realization by the estate. Since a secured cedent's full rights in the collateral are maintained by the Plan, Petitioner Allstate cannot be heard to complain about its treatment. Clearly, a slight modification in the procedure for payment from collateral does not amount to a deprivation of due process rights under the rule in *Neblett*.

D. THE SPECIFIC CONTRACT PROVISIONS RELIED UPON BY PETITIONER WERE NOT ENTERED INTO THE RECORD BELOW; IN ANY EVENT, THE PLAN DOES NOT VIOLATE THE CONTRACT CLAUSE

Petitioner has not even attempted to meet its threshold burden of demonstrating that it in fact possesses contractual rights altered by the law. *National Railroad Passenger Corp. v. Atchison, Topeka & Santa Fe Railway Co.*, 470 U.S. 451, 472 (1985). Petitioner claims that it was a party to various reinsurance contracts with Mutual Fire,

which contained provisions concerning security/collateral, arbitration and setoff. (Petition, p. 4.) Then, Petitioner argues that the Plan "severely restricts" each of these provisions. (Petition, pp. 5, 9-10.) However, these crucial reinsurance contracts, which Petitioner insists have been abrogated by the Plan, were never made part of the record in the state court proceedings. These absent contracts, which now are at the very heart of Allstate's request that this Court review the Pennsylvania Supreme Court's decision on the Mutual Fire Plan, were obviously not important enough to warrant their admission as evidence during the course of four days of hearings.

In any event, the Pennsylvania Supreme Court addressed the Contract Clause challenge raised by Petitioner (A15-16) and properly found that the Plan satisfied the three-part test set forth by this Court in *Energy Reserves*. The Pennsylvania Supreme Court found that any actual contractual impairments as a result of the Plan "are insubstantial." (A15.) The Court also concluded, citing the decision of the Pennsylvania Commonwealth Court in *Vickodil, supra*, that the exigencies associated with a major insurance insolvency and the goals of rehabilitation (minimizing the harm to *all* affected parties) "necessitate the reality" that individual interests may have to be compromised "to avoid greater harm to a broader spectrum of policyholders and the public." (A15.)

Inexplicably, Petitioner suggests that the foregoing analysis by the Pennsylvania Supreme Court is faulty because this Court's requirement in *Energy Reserves* that a statute (which substantially impairs contractual rights) serve "a legitimate and significant purpose," is only *dicta*. (Petition, pp. 25-26.) Quite the contrary, it is well settled

that the prohibition in Article I, Section 10 of the United States Constitution against impairing the obligations of contracts "is not to be read literally," *Keystone Coal Assoc. v. DeBenedictis*, 480 U.S. 470, 502 (1987), but must be accommodated to the inherent power of the state "to safeguard the vital interests of its people." *Energy Reserves*, 459 U.S. at 410. The Pennsylvania Supreme Court's decision approving the Plan leaves absolutely no doubt that the Plan provisions being challenged by Petitioner are reasonable and legitimately designed to foster the goals of rehabilitation in Pennsylvania.

Likewise, Petitioner's attempt to separate itself from the gas suppliers in *Energy Reserves* strains credulity. Allstate's argument that the Plan constituted "a sudden and unanticipated retroactive modification" to the commercial expectations of major reinsurers in the United States is difficult to accept. (Petition, p. 25.) The Pennsylvania Supreme Court specifically noted that:

> . . . the objectors to the Plan are members of a highly regulated industry *and as such were well aware of the powers of the Rehabilitator.* (emphasis added.)

(A16, n.4.)

Indeed, the current Pennsylvania Insurance Department Act, in effect since 1977, and decisions issued thereunder, place substantial emphasis upon the broad powers of the Insurance Commissioner, as rehabilitator, "to effectuate equitably the intent of the Rehabilitation statutes, *i.e.*, to minimize the harm to *all* affected parties." (A15.)

Moreover, the National Association of Insurance Commissioners (NAIC) Model Act, upon which the Pennsylvania Insurance Department Act is based, has been in existence for almost 25 years (with the Wisconsin Insurance Law serving as the original model legislation) and is well known to members of the reinsurance industry. Therefore, it is difficult to believe that Petitioner Allstate was surprised in this case.

CONCLUSION

For the foregoing reasons, it is submitted that the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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(3)

No. 92-873

Supreme Court, U.S.
FILED
DEC 22 1992
OFFICE OF THE CLERK

In The

Supreme Court of the United States

October Term, 1992

RHINE REINSURANCE CO., LTD.; AMERICAN INTERNATIONAL GROUP, INC.; THE HOME INSURANCE COMPANY; NATIONWIDE MUTUAL INSURANCE COMPANY; RESOLUTE REINSURANCE COMPANY AND ARKWRIGHT MUTUAL INSURANCE COMPANY (AS SUCCESSOR IN INTEREST TO PHILADELPHIA MANUFACTURERS MUTUAL INSURANCE COMPANY),

Petitioners,

vs.

CYNTHIA MALESKI, Acting Insurance Commissioner of the Commonwealth of Pennsylvania as Rehabilitator of the Mutual Fire, Marine & Inland Insurance Company *et al.*,

Respondents.

Petition for a Writ of Certiorari to the Supreme Court of Pennsylvania

SUPPLEMENTAL BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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8

LIST OF PARTIES

The Petitioners include Rhine Reinsurance Co., Ltd., American International Group, Inc., The Home Insurance Company, Nationwide Mutual Insurance Company, Resolute Reinsurance Company, and Arkwright Mutual Insurance Company (as successors in interest to Philadelphia Manufacturers Mutual Insurance Company).[1] Other parties to the case include: American Centennial Insurance Co., American Financial Corp., Atlantic Mutual Fire Insurance Co., Crum and Forster, European General Reinsurance Company of Zurich, Excess and Casualty Reinsurance Association, Gerling Global Insurance Corp., The Hartford Insurance Group, Heddington Insurance, Highlands Insurance Co., Imperial Casualty and Indemnity Co., Lincoln

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1. The parent companies of Rhine Reinsurance Co. Ltd. include the Baloise Insurance Co. Ltd., Berner Allgemeine Holdinggeselischaft, Patria Life Insurance Co., and Limmat Insurance Co. Ltd.

Starr International Co., Inc., The Starr Foundation, and C. V. Starr & Co. have an ownership interest in The American International Group, Inc. Its non-wholly owned subsidiaries include INTASCO Holdings Ltd., China America Insurance Co. Ltd., China America International Insurance Co. Ltd., General Environmental Management Co., Venture Enterprises Ltd., Specialty Enterprises Ltd., American International Company Ltd., AIG Financial Products Corp., Tincino Societa d'Assicurazioni Sulla Vita, Expert Network Inc., The Phillipine American Life Insurance Co., AIG Life Insurance Co., and Trace Network International Ltd.

Home Holdings, Inc. is the parent company of The Home Insurance Company.

Nationwide Cash Management is a non-wholly owned subsidiary of Nationwide Mutual Insurance Company.

Resolute Group, Inc. is the parent company of Resolute Reinsurance Company. GEICO Corporation is the parent of Resolute Group, Inc.

F.M. Insurance Company Ltd. and Factory Mutual Engineering Corporation are non-wholly owned subsidiaries of Arkwright Mutual Insurance Company.

Insurance Co., Maiden Lane Insurance Co., Michigan Mutual Insurance Co., Mid-Continent Casualty Co., Monroe Guarantee Insurance Co.,Mutual Marine Offices, Inc., North Star Mutual Insurance Co., Northwestern National Casualty Co., Norwich Union Fire Insurance Society, Ltd., Old Republic, Pennsylvania National Insurance Companies, Royal Insurance Companies, Royal Insurance (UK), Ltd., Safety Mutual Casualty Corp., Saskatchewan Government Insurance, Scottish & York International Insurance Group, South Central Insurance Co., Sphere Drake Underwriting Management, Ltd., Utica Mutual Insurance Co., H. S. Weavers Agencies, Ltd., Willis Faber (Underwriting Management), Ltd., Wausau Insurance Companies, The Republic Insurance Group, NAIC Reinsurance Corporation, Winterthur Reinsurance Corp. of America f/k/a in the U.S. as Winterthur Swiss Insurance Co., U.S. Branch, GTE Reinsurance Co., Ltd., Christiania General Insurance Corp. of New York, Reinsurance Corp. of New York, Evanston Insurance Company, RLI Insurance Company, Pepsi-Cola Bottling Co. of Charlotte, Inc., Pennsylvania Insurance Guaranty Association, Allstate Insurance Co., Fireman's Fund Insurance Co., Interstate Fire & Casualty Co., and Committee of Policyholders.

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This supplemental brief is filed pursuant to Supreme Court Rule 15.7, in order to call the Court's attention to a new decision not available when Petitioners' Petition for a Writ of Certiorari ("Petition") was filed. In their Petition, Petitioners cited a decision of the California Court of Appeals, *Prudential Reinsurance Company v. The Superior Court*, 6 Cal. App. 4th 275, 256 Cal. Rptr. 386 (1990), *aff'd slip op.* No. SO14036, 1992 WL 347585 (Cal. 11/30/92), which involved the issue of reinsurers' rights of offset against an insolvent insurer, Mission Insurance Company ("Mission"). Petitioners did so in support of their argument that, under this Court's decision in *Energy Reserves Group, Inc. v. Kansas Power and Light Company*, 495 U.S. 400 (1983), protecting the interests of policyholders is not a public purpose sufficiently "significant and legitimate" to permit an insolvent insurer to repudiate its contractual setoff obligations with its reinsurers. Petition at 18, n. 12. After the Petition was filed, the California Supreme Court affirmed the Court of Appeals decision. Slip op. No. SO14036, 1992 WL 347585 (Cal. 11/30/92).

In doing so, the California Supreme Court ruled that enforcing the reinsurers' rights of setoff was compelled by their contracts with Mission and state law, and therefore outweighed any asserted public interest in protecting policyholders or another general class of Mission creditors, even if "allowance of a setoff permits reinsurers to obtain complete satisfaction of the debt they are owed, while Mission policyholders are relegated to partial satisfaction only." *Prudential Reinsurance*, slip op. at [illegible]. The Court rejected the argument that "the insolvency statutes were adopted to protect the interests of policyholders and the public in general and setoff would abrogate that protection," *Prudential Reinsurance*, slip op. at 16, finding instead — as Petitioners have argued — that to disallow setoff "would not only subvert clear legislative intent, but would also lead to an increased cost of insurance for the consumer, because offsetting an insurer's debts spreads the risk incurred by the insurer and often allows smaller

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insurers to remain in business." *Prudential Reinsurance*, slip op. at 2; *cf.* Petition at 8-9 and n. 7.

The California Supreme Court's decision in *Prudential Reinsurance* is in conflict with the decision of the Pennsylvania Supreme Court that is the subject of the Petition, thereby providing a basis additional to that set forth in the Petition for granting the requested Writ of Certiorari. The Pennsylvania Supreme Court ruled that the Contract Clause did not require it to modify or amend Mutual Fire's Plan of Rehabilitation ("Plan") even though the Plan ignored the setoff clauses found in Petitioners' agreements with Mutual Fire. The Pennsylvania Court found that the Plan created no "substantial impairment" of the agreements, and further that any impairment that might exist was outweighed by the Commonwealth's "significant interest" in regulating the fiscal affairs of insurers. Petition at 16a, n. 4. The Pennsylvania Court made this determination in spite of a Pennsylvania state statute that requires the setoff of mutual debts or mutual credits between an insurer in rehabilitation and its creditors, except of premiums owed the insurer. 40 P.S. § 221.32. *See* Petition at 11.

In marked contrast to the approach taken by the Supreme Court of Pennsylvania, the California Supreme Court acknowledged that the contracts between an insolvent insurer and its reinsurers allow for offset by either party of "any and all reinsurance debts owed by or to them." Slip op. at 3. It then noted that, under the California equivalent of 40 P.S. § 221.32, these contractual obligations must survive the insolvency of the insurer provided the debts to be offset are "mutual." Slip op. at 4; Cal. Ins. Code, Art. XIV, § 1031. The California Court concluded that "the reciprocal reinsurance contracts at issue here created 'mutual credits and debts'" that must be offset pursuant to the relevant statute. Slip op. at 2.

The decisions of the California and Pennsylvania Supreme Courts cannot be reconciled. Had the Pennsylvania court accepted,

as did the California court, the plain meaning of the Petitioners' contracts with Mutual Fire and enforced, as did the California court, the statutory provision mandating setoff, it would not have so blithely dismissed Petitioners' Contract Clause arguments. To be consistent with *Prudential Reinsurance*, the Pennsylvania Supreme Court would have been obliged to determine that the Plan substantially impairs Petitioners' contractual rights. It would also have had to conclude that the Plan serves no "significant and legitimate public purpose," but rather frustrates the important general goal of promoting security among reinsurers and spreading risk.[1]

The *Prudential Reinsurance* case makes clear that Petitioners' rights under the Contract Clause cannot properly be analyzed without considering their agreements with Mutual Fire or the provision of state law mandating setoff. A similar conclusion is reached by applying to Petitioners' claims this Court's decision in *Energy Reserves*. Accordingly, this Court should grant the Petitioners' Petition in order to correct the Pennsylvania Supreme

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1. The California Supreme Court in *Prudential Reinsurance* apparently considered the Pennsylvania Supreme Court decision in the present case, observing in a footnote that the facts before the Pennsylvania court were distinguishable from those in *Prudential Reinsurance* because 40 P.S. § 221.32(a)(4), unlike Section 1031 of the California Insurance Code, "expressly prohibits reinsurer setoff of premium obligations." Slip op. at 9, n. 4. As noted in the Petition, Petitioners believe that 40 P.S. § 221.32(a)(4) violates the Contract Clause and should be ruled unconstitutional.. Petition at 12, n. 10. They also believe, based upon the language of this provision and its context, that it does not compel a different result from that reached in *Prudential Reinsurance*. In any event, however, it is clear that had the Pennsylvania Supreme Court followed the reasoning of the Court in *Prudential Reinsurance*, it would have reached and decided the issue of the constitutionality of § 221.32(a)(4) and its applicability to this case. The Writ of Certiorari should be granted so that this Court may determine whether the Pennsylvania Supreme Court should have considered this issue instead of ignoring it.

Court's failure to act consistently with the Court's directives in evaluating claims under the Contract Clause.

Respectfully submitted,

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No. 92-873

IN THE

Supreme Court of the United States

October Term, 1992

ALLSTATE INSURANCE COMPANY,
Petitioner,

vs.

CYNTHIA MALESKI, Acting Insurance Commissioner of the Commonwealth of Pennsylvania as Rehabilitator of The Mutual Fire, Marine & Inland Insurance Company, *et al.*,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

SUPPLEMENTAL BRIEF OF ALLSTATE INSURANCE COMPANY

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PARTIES TO THIS PETITION

Petitioner

Allstate Insurance Company

Respondents

Cynthia Maleski, Acting Insurance Commissioner of the Commonwealth of Pennsylvania, as Rehabilitator of The Mutual Fire, Marine and Inland Insurance Co.

Committee of Policyholders

Colonial Penn Group, Inc.

AIG Risk Management

Pepsi-Cola Bottling Co. of Charlotte, Inc.

Fireman's Fund Insurance Co.

Evanston Insurance Co.

RLI Insurance Co.

Pennsylvania Insurance Guaranty Assn.

Member Companies of Republic Insurance Group

RULE 29.1 STATEMENT

Parent:

Sears, Roebuck and Co. (USA)

Non-wholly owned subsidiaries:

ABP Midwest, Inc. (USA)
Allscrips Pharmaceuticals, Inc. (USA)
Associated Gas Resources, Inc. (USA)
Burkhart—AS 1983 Limited Partnership (USA)
DM Management Company (USA)
Fallowfield Developers Limited Parnership (USA)
Quantitative Data Systems, L.P. (USA)
Sanguine/A Anaderko, Ltd. (USA)
Sangatuck, II Cellular Investment Corp. (USA)
Science Center Associates (USA)
Scripps Center Associates (USA)
Washington Business Park Associates (USA)

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Respondents.

PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

SUPPLEMENTAL BRIEF OF ALLSTATE INSURANCE COMPANY

Petitioner, Allstate Insurance Company, filed with this Court a Petition for Writ of Certiorari to the Supreme Court of Pennsylvania on November 19, 1992 (Case No. 92-873). Eleven days later, the Supreme Court of California decided the case of *Prudential Reinsurance Company v. The Superior Court of Los Angeles County*, No. S014036, 1992 WL 347585 (Cal., November 30, 1992).[1] This Supplemental Brief is filed pursuant to Supreme Court Rule 15.7.

The *Prudential* case is germane to this Court's decision on whether to grant the Petition because it emphatically repudiated an insurance commissioner's efforts to substantially impair a reinsurer's contractual setoff rights. The court refused to follow public policy arguments and arguments founded in equity in determining whether the contractual right of setoff as guaranteed by state statute could be abrogated by a state court in an insurance company liquidation proceeding. In addition, the *Prudential* case recognized that a reinsurer can setoff amounts it owes a defunct insurance company even though the obligations are not fully liquidated until after the liquidation proceeding has been commenced.

[1] As of the date of printing of this Supplemental Brief, the *Prudential* case was not reported. Petitioner will file a Westlaw copy of the *Prudential* case to be lodged in this proceeding in lieu of having the case reprinted. All references to page numbers of the *Prudential* case will be to the Westlaw "star" pagination (*e.g.*, *1).

ARGUMENT

I. Rejection of the Insurance Commissioner's "Public Policy" and "Equitable Considerations" Assertions.

In its petition, Petitioner argues that under *Neblett v. Carpenter*, 305 U.S. 297 (1938), creditors of a defunct insurance company must receive under a rehabilitation plan at least what such creditors would have received upon liquidation in order for the plan to meet constitutional requirements. Petitioner asserts that its contractual right to offset mutual obligations, as sanctioned by Section 221.32 of the Pennsylvania Statutes, is impaired under the Respondent's rehabilitation plan. The Pennsylvania Supreme Court relied on *Energy Reserves Group, Inc. v. Kansas Power and Light Co.*, 459 U.S. 400 (1983), for the proposition that contract rights can be impaired by state law if the state is prompted by a significant and legitimate state interest. The *Prudential* case is significant because of its rejection of the public policy arguments and equitable arguments relied on by the Pennsylvania Supreme Court in finding that the impairment of Petitioner's contractual setoff rights for the purpose of providing preferential distributions to policyholders served a legitimate state interest.

The Supreme Court of Pennsylvania held that public policy and equitable principles permitted the abrogation of Petitioner's contractual setoff rights. In addressing the effect of the Rehabilitation Plan on Petitioner's contractual setoff rights, the Court stated, "we find no error or abuse of discretion with this portion of the Plan as it is legitimately designed to ameliorate a financial hazard for the good of all involved." Pet. App. at A17.

In addition, the Court stated that setoff rights can be impaired because they are "not mandatory" and are "permitted solely within the sound discretion of the Court." *Id.* at A18. Clearly, public policy considerations and general equitable arguments served as the Court's justification for abrogating Petitioner's contractual setoff rights in violation of the rule established by this Court in *Neblett v. Carpenter.*

In the *Prudential* case, the Supreme Court of California rejected the insurance commissioner's argument that these same public policy and equitable arguments were adequate grounds for ignoring the statutory setoff provision. The court limited its consideration to the construction of the California statute permitting setoff. The court rejected arguments against setoff which called for judicial favoritism of one group of claimants (*i.e.*, policyholders) over another (*i.e.*, cedents) on purported equitable or public policy grounds. 1992 WL 347585 at *13. To be consistent with the California Supreme Court in *Prudential,* the Pennsylvania Supreme Court should have ignored the Respondent's public policy and equitable arguments and ruled that the Petitioner's contractual setoff rights, as sanctioned by state statute, were unconstitutionally impaired by the plan.

II. Rejection of the "Lack of Mutuality" Assertions.

The *Prudential* case is significant also because it rejected the insurance commissioner's arguments regarding mutuality for purposes of determining whether obligations owed between two parties can be setoff against each other. *Prudential* supports Petitioner's argument that the rehabilitation plan *substantially* impairs its contractual setoff rights in violation of the U.S. Constitution. The commissioner in *Prudential* argued that the obligations were not mutual because the debts owed by the reinsurers to the defunct insurance company (namely, payments on insured losses) are post-liquidation debts while those owed to the reinsurers by the defunct insurance company (namely, past due premiums owed pre-liquidation), are pre-liquidation debts. The commissioner reasoned that the debts owed by the reinsurers are post-liquidation because they are not in fact due until the policyholders' loss claims are liquidated, an event which occurs post-liquidation. Under the commissioner's argument, pre-liquidation debts cannot be setoff against post-liquidation debts. However, in *Prudential* the California Supreme Court followed *O'Connor v. Insurance Company of North America*, 622 F. Supp. 611 (N.D. Ill. 1985), and held that because the reinsurance contracts existed prior to the insolvency proceeding, the debts became payable on the date of insolvency and thus were deemed to be pre-liquidation. *Prudential*, 1992 WL 347585 at *6-7. Because the obligations between the reinsurer and the defunct insurance company were both pre-liquidation, the California Supreme Court in *Prudential* held that those obligations could be setoff against each other.

The Pennsylvania Supreme Court confirmed the rehabilitator's plan which did not permit this kind of setoff. The plan set December 4, 1986 as the date for determining the amount of the setoff. The plan does not permit the setoff of claims which became liquidated after December 4, 1986 and were due and owing as of the purported effective date of the Plan, January 23, 1990. It seems clear that under the reasoning in *Prudential*, the plan confirmed below constitutes a substantial impairment of Petitioner's contractual setoff rights because it precludes Petitioner from setting off mutual claims as of the date of the Plan, thus providing Petitioner substantially less than what Petitioner would receive upon liquidation. The abrogation of these contractual rights is in violation of the Contracts Clause of the United States Constitution, U.S. Const., art. I, §10, cl. 1.

CONCLUSION

The decision of the California Supreme Court in the *Prudential* case provides an additional basis for granting the Writ of Certiorari.

Respectfully submitted,

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PETITION FOR A WRIT OF CERTIORARI
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REPLY BRIEF OF ALLSTATE INSURANCE COMPANY

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No. 92-873

IN THE

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CYNTHIA MALESKI, Acting Insurance Commissioner
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PETITION FOR A WRIT OF CERTIORARI
TO THE SUPREME COURT OF PENNSYLVANIA

REPLY BRIEF OF ALLSTATE INSURANCE COMPANY

This Reply Brief of Petitioner, Allstate Insurance Company, addressing matters first raised in the Brief in Opposition (hereafter, "Respondent's Brief"), is filed pursuant to Supreme Court Rule 15.6.

Petitioner seeks review of a decision of the Pennsylvania Supreme Court which approved a plan of rehabilitation (the "Plan") for an insolvent insurance company, The Mutual Fire, Marine & Inland Insurance Company ("Mutual Fire"). The Petition raises federal constitutional challenges to (1) the Plan's abrogation of Petitioner's contractual arbitration rights and (2) the Plan's impairment of Petitioner's contractual setoff rights and contractual rights in respect of its collateral.

A response to Respondent's Brief is necessary because Respondent made specious arguments to support its claim that Petitioner will receive under the Plan at least what it would receive on liquidation. The Plan blatantly ignored state statutes dealing with the liquidation of insurance companies. The Plan was a means by which the Rehabilitator could reshuffle liquidation priorities amongst various creditor groups. The lower courts approved the Plan because they thought it was for the good of all. However, the Plan provides substantially less to Petitioner than what Petitioner would receive on liquidation. Thus, Petitioner's contractual rights were unconstitutionally abrogated.

I. Evidentiary Status of Petitioner's Contracts.

Respondent argues that Petitioner waived any Contracts Clause or Due Process Clause challenges to the Plan provisions dealing with setoff because the contracts were not introduced into evidence at the hearing before the Commonwealth Court (Resp. Brief at

21). She is wrong. The Commonwealth Court admitted Cedents' Exhibit 1 as evidence of the standard reinsurance contract which contained setoff provisions. The Commonwealth Court specifically overruled an objection by Respondent that the cedents, including Petitioner, could not rely on a standard clause for their arguments but instead should be required to introduce the approximately 8,000 different contracts in use (Tr. at 355-56). Finally, the record is replete with testimony as to the existence in the cedents' contracts of setoff provisions allowing precisely that to which Petitioner claims it is constitutionally entitled (Tr. at 355, 435, 451).

II. Disguised Liquidation.

The Pennsylvania legislature enacted two sets of statutes governing insolvent insurance companies, one providing for liquidation, P.S. §§221.19-221.52, and the other providing for rehabilitation, P.S. §§221.14-221.18. Presumably, the legislature had a reason for doing so. However, Respondent and the Pennsylvania courts, in an effort to impose a public policy different from that expressed by the legislature, ignored those statutes. In the lower courts, Respondent devised out of whole cloth a new scheme for liquidating an insurance company through a plan of rehabilitation. Respondent obviously did this for the purpose of providing her own liquidation priority scheme which treats creditor priorities different from the priorities under the liquidation statutes.[1]

Respondent's accusation that Petitioner misled this Court by referring to Mutual Fire as a "defunct" insurer is absurd. Even the Commonwealth Court was forced to

[1] Petitioner believes that this was done to prefer policyholders over other creditors, including Petitioner; but whatever the motive, the Plan provides significantly less to Petitioner than Petitioner would receive on liquidation.

recognize that, "of course, no one disputes that the rehabilitation as proposed contemplates the windup of Mutual Fire's current business. . . ." (Pet. App. at A50). Mutual Fire will never again operate as an insurance company. Mutual Fire has written no insurance business since 1986, and neither the Plan nor the financial projections used in obtaining approval of the Plan contemplated any income from new business (Tr. at 210). There was no evidence that the Rehabilitator, or anyone else for that matter, thought or intended that Mutual Fire would ever write new business. For all intents and purposes Mutual Fire is a defunct insurance company.[2]

The Pennsylvania Supreme Court stated that because the Plan provides flexibility and the accelerated disposition of claims, the Plan is preferable to liquidation (Pet. App. at A14). The court then stated, ". . . we affirm the Commonwealth Court's holding that this is a legitimate plan of rehabilitation intended for the benefit of the public and not a *de facto* plan of liquidation." (Pet. App. at A15).

The Pennsylvania statutes provide for liquidation of insurance companies which cannot be rehabilitated. P.S. 221.18. Were the liquidation statutes not passed for the benefit of the public? When the court referred to "flexibility" as a reason for preferring the Plan over

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[2] The Pennsylvania Supreme Court also stated that the Plan met the requirements for rehabilitation because it required Mutual Fire to retain its nominal required capital and surplus minimums. Notwithstanding the maintenance of a corporate shell, Mutual Fire's insurance business ceased to exist in 1986 and for all practical purposes will not exist again. Courts passing on this precise issue have held that state rehabilitation statutes can properly be invoked only to "rehabilitate" the business of insurance of the insolvent entity, and that the continued existence of the corporate shell is irrelevant to the analysis. *E.g., In re American Investors Assurance Co.*, 521 P.2d 560, 561-62 (Utah 1974).

statutory liquidation, the court actually was referring to the Rehabilitator's scheme of changing the liquidation priorities from the priorities set forth under the liquidation statutes.

The fact that Mutual Fire should have been liquidated under the liquidation statutes is relevant to the analysis that this Court must make in determining whether to grant the Petition. The Plan was intended to shift the liquidation priorities of Mutual Fire's creditors, ostensibly for the benefit of the public. However, the Plan unconstitutionally abrogated Petitioner's rights because Petitioner receives substantially less under the Plan than it would receive on liquidation.

III. *Neblett* Analysis.

A. The Plan's effect on setoff rights.

A review of the Plan as amended by the Commonwealth Court demonstrates that, notwithstanding Respondent's assertions, Petitioner will not receive under the Plan substantially all that Petitioner would receive if Mutual Fire were liquidated as required by this Court's decision in *Neblett v. Carpenter*, 305 U.S. 297 (1938). Under the Plan, Petitioner's setoff rights are limited to a dollar amount equal to the paid losses in existence on December 4, 1986. Resp. Brief at 16-17 & n.11. December 4, 1986 is the date the Insurance Commissioner petitioned to place Mutual Fire into rehabilitation. The Pennsylvania courts incorrectly assumed that the *Neblett* decision required the court to analyze what creditors or policyholders theoretically would have received if Respondent had petitioned for liquidation at the time Respondent filed the original petition for rehabilitation (*i.e.*, December 4, 1986) (Pet. App. at A20-23).

The appropriate analysis, however, is to determine whether creditors will receive under the Plan at least what those creditors would receive if the company were liquidated at the time the court considered approving the Plan. This conclusion is supported by the Pennsylvania statutes. Section 221.18 of the Pennsylvania Statutes provides that the Rehabilitator can petition the court for a liquidation order if prior attempts to rehabilitate the insurer have proven futile. If a liquidation order is entered, the rights of the parties for purposes of liquidation under the Pennsylvania statutes (including the setoff provision in P.S. §221.32) are fixed as of the date of the petition for liquidation. P.S. §221.20(d). The statutes do not contain a similar provision fixing the rights of the parties in a rehabilitation proceeding.

At some point Respondent became aware of the futility of the rehabilitation of Mutual Fire's business. At this juncture Respondent had two choices: petition for a liquidation order, P.S. §221.18, or press the Commonwealth Court to approve a liquidating rehabilitation plan which provided creditors what they would receive on liquidation.

Had Respondent petitioned for liquidation, the ensuing liquidation order would have had the effect of fixing Petitioner's setoff and other rights as of the date Respondent petitioned to convert the case to a liquidation proceeding (*i.e.*, no earlier than 1990). P.S. §§221.18, 221.20(d). In the interim between the original petition for rehabilitation in 1986 and the time when Respondent would have petitioned for liquidation in 1990, many of the mutual obligations between Mutual Fire and Petitioner, in the form of case reserves and IBNR, matured into paid losses, thus substantially increasing Petitioner's setoff rights.

Instead, however, Respondent chose to file a liquidating plan which purported to fix Petitioner's rights retroactively as of December 4, 1986, even though no liquidation order had ever been entered which would have fixed Petitioner's rights. By this act, Petitioner's contractual setoff rights were substantially impaired because Petitioner's paid losses were much greater in 1990 than they were on December 4, 1986.

This impairment violates Petitioner's constitutional rights. This is not merely a matter of a state court interpreting state law. This is a matter of a state court misapplying a federal constitutional standard. In her zeal to provide liquidation priorities for creditors different from the priorities set forth in the liquidation statutes, Respondent ignored state law in derogation of Petitioner's constitutional rights guaranteed by *Neblett*. It is beyond dispute that this Court has jurisdiction to review such issues. *Energy Reserves Group, Inc. v. The Kansas Power and Light Company*, 459 U.S. 400 (1983).

B. The Plan's effect on Petitioner's rights as a secured creditor.

Notwithstanding Respondent's assertion that Petitioner's rights to its collateral are unaffected by the Plan, Petitioner receives under the Plan far less favorable treatment as a secured creditor than Petitioner would receive on liquidation. Respondent concedes that collateral trusts and letters of credit secured cedents' claims for paid losses, case reserves and IBNR (Tr. at 215, 216). Respondent further concedes that under the Plan, a secured cedent's resort to its collateral is limited to drawing from a collateral trust or drawing down on letters of credit only for paid losses as those losses develop over time. *Id.*

Petitioner's contractual rights have been substantially impaired because Petitioner (a cedent) is not permitted by the Plan to resort to the collateral for all of the obligations owed it by Mutual Fire, including case reserves and IBNR. As Petitioner argued in its brief to the Pennsylvania Supreme Court at pages 20-37, in a liquidation, the Pennsylvania statutes allow secured creditors to obtain all their collateral. This would include the right to use collateral to pay case reserves and IBNR, in addition to paid losses. Petitioner's rights are also impaired by the Plan's requirement that Petitioner obtain Respondent's permission before resorting to the collateral. Petitioner has been denied Respondent's permission to resort to its collateral for the three years since the Plan was approved—indeed, for the seven years since Respondent took control of Mutual Fire. As a result, Petitioner has been denied the use of its collateral, and the opportunity to invest the proceeds of the collateral. Petitioner's rights as a secured creditor are unconstitutionally impaired by the Plan under the *Neblett* standard.

IV. *Energy Reserves.*

Neblett is the gauntlet which protects the rights of creditors in insurance insolvency and rehabilitation proceedings. If *Energy Reserves Group* means that a state may impair contractual interests if it rests on and is prompted by significant and legitimate state interests, such state interests do not exist with respect to the liquidation of Mutual Fire.

Under *Energy Reserves*, this Court recognized that the State of Kansas exercised its police power by enacting statutes to protect consumers from the escalation of natural gas prices caused by deregulation and that the state had a legitimate interest in correcting the imbalance between the interstate and intrastate

markets. In this case, there cannot possibly be a legitimate state interest to protect by approving a rehabilitation plan which liquidates Mutual Fire in a manner which is different from the way it would be liquidated under the state's extant liquidation statutes. Thus, the Commonwealth of Pennsylvania had no legitimate state interest in abrogating Petitioner's contract rights, and for that reason Petitioner's constitutional rights were violated.

V. Arbitration Rights.

As explained in the Petition, Section X of the Plan provides that a party to a dispute may request the Commonwealth Court to hear the dispute in lieu of arbitration. The court is required to grant the request if it is in the best interest of the estate (Pet. App. A112). It is clear that the Plan approved by the Pennsylvania courts does not require arbitration in all cases where the dispute is governed by a contractual arbitration clause. In fact, Respondent admits that, under the Plan, whether or not to allow arbitration of a given dispute is to be determined in the discretion of the Commonwealth Court on a case-by-case basis (Resp. Brief at 13). In Respondent's view, granting discretion to the Commonwealth Court does not constitute an abrogation of Petitioner's arbitration rights because, the argument goes, the court *might* allow Petitioner to arbitrate its disputes. *Id.*

However, the possibility that a court might allow arbitration of a dispute governed by an arbitration clause was not good enough for the United States Congress when it enacted the Federal Arbitration Act. Congress obviously was concerned with the possibility that a court *might not* allow arbitration. The Supremacy Clause requires the Commonwealth of Pennsylvania to enforce

the Federal Arbitration Act in all cases governed thereby. *Southland Corp. v. Keating*, 465 U.S. 1 (1984). The Pennsylvania courts may not approve a rehabilitation plan for an insolvent insurance company which, by its terms, is contrary to the requirements of the Act.

Contrary to Respondent's assertions, this issue is ripe for adjudication because the Plan abrogates the Petitioner's rights to arbitration by making such rights dependent upon a Pennsylvania court's discretion. The contractual arbitration rights have already been abrogated by the Plan itself.

Respondent also argues that Petitioner waived this issue in the courts below (Resp. Brief at 11-14). On the contrary, Petitioner did not waive the issue, and the record is sufficiently developed to permit this Court's review. As stated in its Petition at 6-8, Petitioner challenged the denial of its arbitration rights, and Respondent specifically addressed the issue of the apparent conflict between the Federal Arbitration Act and the McCarran-Ferguson Act in her brief to the Pennsylvania Supreme Court (Rehabilitator's Brief to Penn. S. Ct. at 90).

VI. The Issues Raised in the Petition are of Great National Importance.

Respondent's Brief improperly portrays as trivial the impairment of Petitioner's contractual rights. This is obviously an attempt to persuade this Court that the matters presented in the Petition are too insignificant to justify a commitment of the Court's limited resources. The reinsurance business in the United States is a multi-billion dollar industry. If states are free to affect the rights of participants in the industry in the manner accomplished by the Pennsylvania courts, the effect on

the reinsurance industry will be tremendously adverse. The issues presented in this case are of national importance and justify the commitment of this Court's resources to their resolution.

CONCLUSION

The Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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